JOURNAL OF LAW, ECONOMICS & POLICY

Cite as 19 J.L. ECON. & POL'Y 164

Journal of Law, Economics & Policy (ISSN: 1553-4367)
George Mason University School of Law
3301 Fairfax Drive
Arlington, Virginia 22201
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www.jlep.net

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THE FUTURE OF FINANCIAL REGULATION AND THE ADMINISTRATIVE STATE: *A SYMPOSIUM FOR THE 20TH ANNIVERSARY OF THE JOURNAL OF LAW, ECONOMICS & POLICY*

Adam J. White[1]
2 April 2024

JLEP's twentieth anniversary is cause for celebration. It's also an opportunity to look ahead to the next two decades and beyond. And it occurs at a pivotal moment in American financial regulation, which is undergoing profound transformations in nearly every respect: in what is being regulated, and how, and by whom.

The subjects of financial regulation are expanding significantly. The Securities & Exchange Commission's recent final rule on climate risk attracted significant attention,[2] and the subsequent litigation will only further elevate the issue. But it is just one part of a much broader effort to bring climate policy into financial regulation.[3] And, to the extent it succeeds in court and as a matter of public policy, it will inspire efforts to incorporate more policy questions into financial regulation.[4]

There surely are several reasons for this development, but one that deserves more attention is the fact that financial regulators often administer statutes that are much more open-ended, and they do so through means that are much more amorphous than administrative law's familiar stuff of notice-and-comment rulemaking. To the extent that an administration bristles under the statutory and procedural constraints on other agencies, the financial regulators will become an increasingly attractive policymaking tool.

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[1] Co-Executive Director, Antonin Scalia Law School's C. Boyden Gray Center for the Study of the Administrative State; Senior Fellow, American Enterprise Institute.

[2] SEC, *The Enhancement and Standardization of Climate-Related Disclosures for Investors*, 89 Fed. Reg. 21668 (Mar. 28, 2024).

[3] *See, e.g.*, Dep't of Treasury *et al.*, *Principles for Climate-Related Financial Risk Management for Large Financial Institutions*, 88 Fed. Reg. 74183 (Oct. 30, 2023); CFTC Climate-Related Market Risk Subcommittee, *Managing Climate Risk in the U.S. Financial System* (Sept. 9, 2020), https://www.cftc.gov/sites/default/files/2020-09/9-9-20%20Report%20of%20the%20Subcommittee%20on%20Climate-Related%20Market%20Risk%20-%20Managing%20Climate%20Risk%20in%20the%20U.S.%20Financial%20System%20for%20posting.pdf.

[4] *Cf.* Gary Gensler & Lily Bailey, *Deep Learning and Financial Stability* (Nov. 13, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3723132 (on artificial intelligence and financial stability); Richard Vanderford, *Big Businesses Should Disclose China Risks, Ex-SEC Chairman Says*, WALL ST. J. (Sept. 12, 2023), https://www.wsj.com/articles/big-businesses-should-disclose-china-risks-ex-sec-chairman-says-68e67fb6.

That said, the financial regulators' own administrative processes may change, too. Most significantly, major financial institutions and their trade groups are increasingly willing to challenge their financial regulators in court.[5] This will implicate substantive standards of review—including *Chevron* deference and the "major questions doctrine"—but it also may cause agencies eventually to undertake more rigorous notice-and-comment procedures,[6] just as judicial review of cost-benefit analysis spurred some regulators to improve that aspect of their process a decade ago.[7]

And, finally, the "who" of financial regulation may be changing too. As financial regulation grows in significance, it becomes a subject of increasing White House interest,[8] and eventually there will be greater interest in incorporating at least some of the regulatory actions from traditionally independent financial regulators. Four decades ago, when President Ronald Reagan first enacted the modern framework for White House regulatory management, one of its architects observed that the financial regulators and other independent regulatory commissions had been exempted from the new Office of Information and Regulatory Affairs' oversight because they did not seem to be of central policymaking importance.[9] Things are much different now, to say the least.

With all of this in mind, our approach for this symposium was straightforward. To some of the best minds on financial regulation, we asked: *what will be the most important financial regulatory issues of the next twenty years*? And to some of the best minds on administrative law, we asked: *how should we think about the convergence of financial regulation and OIRA?*

Their responses, in the pages that follow, are a genuinely great collection of essays.

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5 Laura Noonan et al., *The U.S. Pushback Against 'Basel Endgame,'* FIN. TIMES (Mar. 19, 2024), https://www.ft.com/content/48555d55-ca6d-4ab8-ae29-aba4d4f10f13; Liz Hoffman, *Big Banks Mull the Unthinkable: Suing the Fed*, SEMAFOR, (Jan. 11, 2024, 1:41 PM), https://www.semafor.com/article/01/11/2024/big-banks-mull-the-unthinkable-suing-the-fed.

6 *Cf.* Chamber of Commerce v. CFPB, 2023 WL 5835951 (E.D. Tex. Sept. 8, 2023) (holding the CFPB's update of its supervisory manual was final agency action).

7 *See, e.g.*, Business Roundtable v. SEC, 647 F.3d. 1144 (D.C. Cir. 2011); Steven Sloan, *Schapiro Says SEC Will Change Cost Calculation of Regulation*, BLOOMBERG (Apr. 17, 2012), https://www.bloomberg.com/news/articles/2012-04-17/schapiro-says-sec-will-change-cost-calculation-of-regulation-1-?sref=NeFsviTJ.

8 *See, e.g.*, Executive Order 13772, *Core Principles for Regulating the United States Financial System*, 82 Fed. Reg. 9965 (Feb. 8, 2017); Exec. Order 14030, *Climate Related Financial Risk*, 86 Fed. Reg. 27967 (May 25, 2021).

9 C. Boyden Gray, then-counsel to Vice President George H.W. Bush and counsel to President Reagan's Task Force on Regulatory Relief, explained this at a press conference at the U.S. Chamber of Commerce on April 10, 1981. *See Role of OMB in Regulation*, H.R. Rep. No. 70, 97th Cong., 1st. Sess. 152 (1981) (reprinting transcript), http://njlaw.rutgers.edu/collections/gdoc/hearings/8/82601518/82601518_1.pdf.

On the future of financial regulation, Stanford's John Cochrane and Amit Seru warn that "the bailout-and-regulate spiral must end."[10] Connecting monetary and fiscal policy to regulatory policy, and drawing from the experience of the 2008 financial crisis, the COVID-19 pandemic, and the recent bank failures, they predict that "the central approach of allowing a fragile and highly leveraged financial system, providing bailouts that incentivize that fragility, but counting on regulators to spot and contain risk[,] is fundamentally doomed."[11]

Columbia's Kathryn Judge is looking beyond recent debates over financial stability too, but for different reasons. She observes that the last decade's overwhelming focus on financial stability has overshadowed two other subjects of financial regulation: anti-money laundering (AML) and housing finance. Indeed, these are two of the most practically important aspects of financial regulation—and, she urges, they both need significant reforms. AML "is one of the most extensive public-private ecosystems," but it "is performing abysmally by some metrics."[12] As for housing finance, "it is past time to stop kicking the can down the road, allowing a regime that is obviously suboptimal by any objective standard, to continue to bilk an implicit public backstop primarily for the benefit of member financial institutions."[13]

Peter Wallison, too, focuses on lending. In 1990, shortly after the savings & loan crisis, the American Enterprise Institute senior fellow called for significant reforms to bank supervision and deposit insurance.[14] Now with the additional experience of the 2008 financial crisis and the recent bank failures, he updates his analysis and reiterates his call for greater private-sector responsibility for policing banks. "It may be that banks require supervision," he concludes, but "incentives can be built into supervision so that banks can be compelled to act safely and soundly the same way that other private sector suppliers of goods and services do. It only takes a bit of imagination and the will to try."[15]

Scalia Law's own Todd Zywicki brings a similar reform-minded approach to this symposium. Surveying the history of consumer financial protection, he sees a "simple, but powerful" theme: "regulation in both structure and substance must adapt to changes in technology and the challenges those

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10 *See infra*, John H Cochrane & Amit Seru*, Ending Bailouts, At Last*, 19 J.L. Econ. & Pol'y 169, 171 (2024).

11 *Id.* at 184.

12 *See infra*, Kathryn Judge*, Financial Regulations Beyond Stability*, 19 J.L. Econ. & Pol'y 194, 205 (2024).

13 *Id.* at 209.

14 PETER WALLISON, BACK FROM THE BRINK: A PRACTICAL PLAN FOR DEPOSIT INSURANCE AND STRENGTHENING OUR BANKS AND THRIFTS (1990).

15 *See infra*, Peter J. Wallison*, A Proposal for Removing Government Agencies from Supervising or Insuring Banks and S&Ls*, 19 J.L. Econ. & Pol'y 211, 222 (2024).

present."[16] Yet the regulatory system is too often slow to "recognize these realities."[17] In our own time, he sees excessive "regulatory barriers that currently stand in the way of greater inclusion of underserved populations."[18] And legislative or regulatory efforts to give customers better information and transparency has had an unfortunate effect: "consumers are buried in disclosures that fail to distinguish in any way between what is truly relevant to the consumer . . . and what is not."[19]

Finally, Yale's Jonathan Macey pans back to much broader trends in American politics and government. He sees political turmoil and institutional decline as profound threats to the rule of law that undergirds free and functioning markets. Specifically, he focuses on the Federal Reserve, federalism, and the courts of law: "structural components of the U.S. regulatory system, particularly the independent central bank, the provisions of corporate law and corporate governance rules at the state rather than the federal level, the independent judiciary and its protection of free speech have worked well to insulate the capital markets from the recent political turmoil."[20] Will they continue to serve that purpose for twenty more years?

Turning more specifically to the future of presidential administration and financial regulation, recent OIRA Administrator Paul Ray grapples directly with the question of whether OIRA should review the financial agencies' rules, and how they might do so. He surveys the benefits of OIRA review (*e.g.*, improving agency analysis and promoting democratic accountability), but also its costs (*e.g.*, slowing the rulemaking process, particularly in multi-member commissions). If those sound familiar, it's no accident: "At day's end," he concludes, "the benefits and costs of OIRA review of [independent financial regulators'] rules would likely be about the same as the benefits and costs of review of executive agency rules"–maybe "not *exactly* the same," but sufficiently close that "[t]hose who find themselves in agreement with the consensus of the last seven presidents about the value of OIRA review" should "have good reason to extend OIRA review" to the independent financial regulators.[21]

On this point, what can we learn from recent experience—namely the White House's recent expansion of regulatory review authority over Internal Revenue Service rules?[22] Minnesota's Kirstin Hickman and Ohio State's

16 *See infra*, Todd J. Zywicki, *Looking Forward by Looking Backward: The Future of Consumer Finance and Financial Protection*, 19 J.L. Econ. & Pol'y 223, 224 (2024).

17 *Id.*

18 *Id.* at 237.

19 *Id.* at 238.

20 *See infra*, Jonathan Macey, *Finance Without Government: Financial Regulation in an Age of Political Unrest*, 19 J.L. Econ. & Pol'y 241, 241 (2024).

21 *See infra*, Paul J. Ray, *A Distinction Without a Difference: On the Case for OIRA Review of Rules by Independent Financial Regulators*, 19 J.L. Econ. & Pol'y 260, 271 (2024) (emphasis in original).

22 *See* Memorandum of Agreement, The Department of Treasury and the Office of Management and Budget, Review of Tax Regulations Under Executive Order 12866 (Apr. 11, 2018),

Bridget Dooling describe dueling narratives. Among OIRA's supporters, "OIRA review brings worthwhile, salutary benefits to the public and the regulatory process." Among its critics, "OIRA review is meddlesome in multiple ways, dismissive of agencies' subject matter expertise, and its analytical methods are not worth the effort they impose"—particularly in the context of tax regulation.[23] Unpacking the arguments, and looking seriously at facts, Hickman and Dooling avoid sweeping conclusions one way or another, but they seem generally optimistic that OIRA review of IRS regulations could be done well, if carefully.[24]

All of these papers were presented at a conference last fall in Washington, D.C., followed by a keynote conversation with the Federal Deposit Insurance Commission's recent chairman, Jelena McWilliams.[25] And the conference also featured an excellent Mercatus Center panel on "regulatory sandboxes" in financial and tech regulations. It featured the last paper in this symposium, in which Ryan Nabil draws lessons from recent years' efforts to apply sandbox frameworks for FinTech, and he applies those lessons to new regulatory debates around artificial intelligence.[26]

The C. Boyden Gray Center for the Study of the Administrative State is grateful to all the conference's speakers, and especially to the authors in this symposium. Most of all, we are grateful for the chance to help commemorate *JLEP*'s twentieth anniversary in the best possible way: by studying recent history and looking to the future.

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https://home.treasury.gov/sites/default/files/2018-04/04-11%20Signed%20Treasury%20OIRA%20MOA.pdf; *but see* Memorandum of Agreement, The Department of Treasury and the Office of Management and Budget, Review of Tax Regulations Under Executive Order 12866 (June 9, 2023) (superseding 2018 agreement), https://www.whitehouse.gov/wp-content/uploads/2023/06/Treasury-OMB-MOA.pdf.

23 *See infra*, Kristen E. Hickman & Bridget C.E. Dooling, *Competing Narratives on OIRA Review of Tax Regulations*, 19 J.L. Econ. & Pol'y 272, 273 (2024).

24 *Id.* at 294 ("[W]e hope this essay sheds some light on the nature of the disagreement and how it might be resolved.").

25 Videos of the panels are available at https://administrativestate.gmu.edu/event/the-future-of-financial-regulation-symposium/.

26 *See infra*, Ryan Nabil, *Artificial Intelligence Regulatory Sandboxes*, 19 J.L. Econ. & Pol'y 295 (2024).

ENDING BAILOUTS, AT LAST[1]

John H Cochrane[2] *and Amit Seru*[3]

INTRODUCTION

In 2008, we had a financial crisis. Our government responded once again with bailouts. Bailouts keep existing business going, and most of all protect creditors from losses. The instruments vary, including direct creditor guarantees like deposit insurance, mergers of failing companies with sound ones sweetened with government money or government purchases of bad assets, or government purchases, guarantees, and other efforts to prop up security prices and thereby cover up losses. Since actual or promised (contingent) resources flow from taxpayers to financial market participants, we include all of these interventions as "bailouts."

Ex-post protection breeds ex-ante risk taking or moral hazard, however. If deposits are guaranteed, depositors have little incentive to seek out safe banks. If banks, financial institutions, and other companies will receive bailouts and are therefore unlikely to default on loans, creditors have little incentive to seek out safe companies, and companies have less incentive to make safe investments.

Recognizing this danger, and responding to public outrage over bailouts, our government promised during the 2008 financial crisis to address moral hazard once the storm had passed. It made good on that promise with a vast expansion of financial regulation under the Dodd-Frank act.[4] Similar approaches were followed internationally, under the Basel international regulatory umbrella.[5] Whether or not one approves of the outcome—we are mostly skeptics—at least one must grant the effort.

2008 was not the first time. For at least a century, we have experienced a regular cycle: Large financial institutions get in trouble, and may go under. Runs develop. The government bails out the creditors, directly or indirectly by bailing out the institutions, which stops runs. The government then adds regulations and institutions to try to constrain the consequent moral hazard

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[1] Prepared for the Gray Center Symposium, "The Future of Financial Regulation," October 6, 2023, Washington DC.

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[4] Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. §§ 5301, 5481-5603.

[5] *See generally Overview of the Prudential Regulatory Framework for U.S. Banks: Basel III and the Dodd-Frank Act*, CONG. RSCH. SERV. (July 27, 2016), https://crsreports.congress.gov/product/pdf/R/R44573/3.

and prevent another crisis. Never again, we say, again and again. Then, people invent ways to get around the regulations, regulators get sleepy, another crisis develops, and the government bails out again. 1907 led to the creation of the Federal Reserve, which failed to stop a banking collapse in 1933. 1933 led to deposit insurance and heavy regulation, which fell apart in the 1970s. Then, from Continental Illinois to the Savings and Loan Crisis, Latin American debt, Long Term Capital Management, the East Asian debt crisis, and finally, the 2008 plunge, the story repeated, larger each time. Bailouts spread to industrial companies, also highly levered, including the auto bailout of 2009.[6]

It just happened again. Fearing another crisis due to the natural and policy-induced economic dislocations of the COVID-19 pandemic in 2020, our government bailed out, breaking many of the Dodd-Frank promises. And again. Silicon Valley Bank and First Republic suffered runs in 2023, triggered by old-fashioned interest rate risk that somehow the army of regulators had completely missed.[7] Credit Suisse failed, and its regulators threw out the resolution plans. These events laid bare that the basic architecture of current financial regulation—allow fragile financing, but count on regulators to contain risk—has failed.

Except, scandalously, this time neither government, nor Fed, nor other regulators have even acknowledged that anything was wrong with these bailouts. There are no "What went wrong?" inquests, no acknowledgement that bailouts induce moral hazard, there are not even promises to mop up moral hazard someday in the vague future. As unproductive as it would be, there is no concerted effort to reform the rule book once again to contain moral hazard or to pre-commit against ever larger bailouts. (The massive "Basel III endgame" rule expansion is not motivated by the failures of 2020-2023.) The main reaction is a self-congratulatory pat on the back for saving the world by spreading out immense amounts of bailout money. Bailouts are the new regime, the new norm, and expected by financial market participants in the next crisis. Perhaps the lack of another popular revolt at "bailing out the banks" led to the unusual quiet, but a technocracy which only reforms when the peasants are outside with pitchforks is not healthy.

Too big to fail is now enshrined. But small companies get bailed out too, and their creditors. Industrial companies, not just financial companies, are protected. Too leveraged to fail might be the summary of our new regime. But our authorities subsidize leverage, with tax deduction and regulatory preferences for debt. As a result, there is every incentive to take risk, to borrow and to lend, with confidence that the government will backstop debt, prop up prices, and keep companies afloat should any serious crisis develop. There is little incentive to issue equity rather than borrow, to keep cash

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6 *See* the brief history of bailouts in the Appendix.

7 *See generally* U.S. GOV'T ACCOUNTABILITY OFF., GAO 23-106736, PRELIMINARY REVIEW OF. AGENCY ACTIONS RELATED TO MARCH 2023 BANK FAILURES 11 (2023), https://www.gao.gov/assets/gao-23-106736.pdf.

around to provide liquidity or hunt for bargains and thereby prop up prices with private money in the next moment of stress. Why be ready to bargain-hunt when you know the government will front-run you and keep prices from falling?

Obviously, it is not healthy that investors get the benefits of risky lending in good times and taxpayers bear the risks in bad times. Worse, the system will sooner or later fall apart. Eventually, the government, even the US government, will run out of the ability or the will to cheaply borrow an immense amount in order to bail out indebted businesses and their creditors. Then we face the worst of all worlds. The ideal intervention comes when nobody expects a bailout: all the mopping up, none of the moral hazard. The worst outcome realizes when everyone expects a bailout but it cannot come. When a town builds a great firehouse, people can start to store gasoline in the basement and neglect their own fire extinguishers. When the firehouse burns down, so does the town.

The bailout-and-regulate spiral must end. The promise of Dodd Frank to finally regulate away risk and bailouts has failed. Inflation shows us that the government is near its limit to borrow and print money to fund bailouts. We have one last chance to construct a bailout-free financial system. Fortunately, plans for such a system are sitting on the shelf. They need only will to overcome the large private interests that benefit from the current system.

THE COVID BAILOUTS

Financial trouble started in March 2020 in the Treasury market, supposedly the safest of all asset markets.

Analysts had long warned of Treasury market fragility and pointed to the failings of Dodd-Frank rules behind that fragility. In September 2019, overnight money market rates suddenly doubled from 2.5% to 5%. Cash withdrawals related to corporate tax payment and treasury debt auction settlement have been named as sources of the sudden demand for cash, but big banks should jump on such an investment opportunity and provide needed funds. Under the post-2008 rules, they were constrained from this normal function. The Fed immediately responded by consecutive overnight repurchase operations of $75 billion to increase cash in the system. In October, the Fed announced the decision to purchase Treasury bills at a steady pace through the second quarter of 2020 and extended overnight and term repo operations.

The Fed intervention in Treasury markets starting in March 2020 was much larger. In previous crises such as 2008, large and foreign investors "flew to safety" and bought Treasurys. This time they flew to cash and sold Treasurys. All treasury trading funnels through a few broker-dealer banks, who allocate only so much regulatory liquidity and capital to treasury buying and selling. Despite attractive spreads, they could not handle the volume of

trading. Prices fell, interest rates rose, and times required to sell securities rose. The Fed deemed this outcome unacceptable, and stepped in.[8]
Duffie describes some of the market turbulence:

> In the US Treasury market, dealers' gross bond inventories and daily purchases of bonds from customers surged to over ten times their 2017-2022 medians. . . . customers of dealers faced bid-offer spreads reaching more than ten times normal and interdealer market depth nearly disappeared at some points. . . . settlement failures soared. [9]

Duffie describes the response:

> The Fed responded by offering virtually unlimited Treasury financing to dealers and by purchasing nearly a trillion dollars of Treasury securities from them over the next three weeks, among other major actions.[10]

In other words, the Fed lent dealers the money to buy Treasurys, and then turned around and bought the Treasurys from the dealers a few days later.

This was not a dealer bank bailout. Dealer banks were making big profits on this trading, buying low and selling high a few days later. They just were unwilling or unable to expand their trading activity under existing capital and liquidity rules. The Fed was unwilling to accept market interest rates rising by up to a percent and the kinds of trading difficulties and profits that attract additional intermediation capital, though not immediately. It is part of a larger pattern, echoed by the European Central Bank (ECB), of declaring bond prices lower than the central bank likes as signs of "dysfunctional" or "fragmented" markets, and stepping in with huge purchases.[11] Bond owners and bond sellers got the bailout, as well as the government which got to borrow at lower rates.

The Fed continued to buy huge amounts of Treasury securities, in exchange for newly created reserves, eventually monetizing about $3 trillion of the $5 trillion new issues of the pandemic. This enormous intervention surely cannot represent fear of continued "dysfunction," as the panic selling quickly stopped. Indeed, the major seller was quickly not large financial institutions, but the federal government itself, issuing unprecedented amounts of new debt to support pandemic spending. If there is "dysfunction" here, it is the beginning of a limited appetite for Treasury debt. We read the continued purchases

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[8] *See* Darrell Duffie et. al., *Dealer Capacity and U.S. Treasury Market Functionality*, FED. RSRV. BANK OF N.Y. (2023), https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr1070.pdf?sc_lang=en.

[9] Darrell Duffie, *Resilience Redux in the U.S. Treasury Market*, at 3, FED. RSRV. BANK OF KAN. (2023), https://www.kansascityfed.org/Jackson%20Hole/documents/9726/JH_Paper_Duffie.pdf.

[10] *Id.*

[11] Comm. Global Fin. Sys., *Central Bank Asset Purchases in Response to the Covid-19 Crisis*, CGFS Papers 68 (Mar. 2023), https://www.bis.org/publ/cgfs68.pdf.

as simple monetization, common in wars and other crises, The government wishes to spend an additional $5 trillion. The central bank buys debt to hold down the government's interest costs.

Whatever the ultimate motivation, the Fed purchased $3 trillion of Treasury securities,[12] with a clear proximate motive to keep up bond prices and down rates.

Money market funds ran in to trouble. People started to withdraw money from money market funds, and the funds were having trouble selling assets fast enough to meet redemptions. The Fed stepped in by initiating the Money Market Mutual Fund Liquidity Facility (MMLF) on March 18, 2020.[13] In this program, the Fed lent money to financial institutions which were willing to buy securities from money market funds, and allowed those borrowers to use the same securities as collateral for the loans.[14] Lending at rates not available on the market and taking as collateral unsellable securities are a transfer, though less obvious than straight out asset purchases.

Fixing a money market run is pretty simple. Money market funds promise a fixed value (one dollar per share) and daily, if not faster access, like bank deposits. They back these promises with short-term liquid securities, unlike banks who back promises with long-term loans and equity. Equity backstops—the fund gets some of its money by issuing equity, or has a sponsor willing to cover shortfalls—"breaking the buck" to trade shares at the actual value of underlying assets, allowing secondary trading of money market fund shares, redemption gates, and other simple reforms can easily make money market funds run-proof. There had been a money-market fund run in 2008, with a similar bailout. The Dodd-Frank reforms were supposed to fix money market runs. They failed.

From March 6 to March 20, 2020, corporate bond prices fell sharply, much more indeed than Treasury prices. The Moody's AAA index rose from 2.36% to 4.12%, and BAA from 3.29% to 5.15%, while the 10-year Treasury rate only rose from 0.54% on March 9 to 1.18% on March 18. The Fed swiftly announced purchase programs for corporate debt, the Primary[15] and Secondary[16] Market Corporate Credit Facilities, put in place March 22, 2020. The primary facility was designed to make it easier for corporations to issue new debt, much as the Fed did for Treasury and State and Local government debt described next. In the Secondary Market Facility, the Fed bought bonds that were already issued before the pandemic, along with exchange-traded bond funds. The objective was simply to prop up bond prices. The Fed did not

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[12] Kate Duguid, *Federal Reserve's $3 Trillion Virus Rescue Inflates Market Bubbles*, Reuters (July 13, 2020), https://www.reuters.com/article/idUSKCN24E13E.

[13] *Money Market Mutual Fund Liquidity Facility*, BD. GOVS. OF THE FED. RSRV. SYS., https://www.federalreserve.gov/monetarypolicy/mmlf.htm (last visited Apr. 1, 2024).

[14] *Id.*

[15] *Primary Market Corporate Credit Facility*, BD. GOVS. OF THE FED. RSRV. SYS., https://www.federalreserve.gov/monetarypolicy/pmccf.htm (last visited Apr. 1, 2024).

[16] *Secondary Market Corporate Credit Facility*, BD. GOVS. OF THE FED. RSRV. SYS., https://www.federalreserve.gov/monetarypolicy/smccf.htm (last visited Apr. 1, 2024).

announce a price target, but unlike previous quantitative easing, it did not announce a quantity limit either. Wall Street widely interpreted the program exactly as price support—the Fed would buy "whatever it takes," in Mario Draghi's famous words, to keep corporate bond prices from falling. The Fed announced that it would only buy investment grade bonds, including "fallen angels," downgraded bonds that were formerly investment grade. The widening spread between non-investment grade and eligible investment-grade debt testifies to the effectiveness of the Fed put. As with Draghi's first intervention, words were enough and prices stayed high without huge purchases. The ECB's later experience cautions us that next time the Fed might actually have to buy large quantities to keep prices from falling.

The Fed has long been accused of offering an implicit stock market "put" option—lowering short term interest rates to keep stock prices from falling. Most recently, in December 2018 the Fed halted its interest rate tightening, perceived to be in response to a tanking stock market. The Fed has bought set quantities of securities, including Treasury debt, mortgage-backed securities, and "toxic assets," with an explicit goal of raising their market prices. But the Fed has never come so close to offering an explicit put option, by which it buys whatever quantity of specific securities it takes to keep prices at a desired level.

Overall, the Fed and its sister central banks have crossed a second Rubicon. They once set a short-term rate, such as the US Federal Funds rate, and let other market prices adjust freely. This limitation on their powers, like the limitation to only pay attention to their price stability and employment mandates, was seen as a price of independence. Central banks now broadly interfere directly and widely in asset prices. The quantitative easing programs of the US Fed and most other central banks aim to raise the prices of long-term Treasury bonds and mortgage-backed securities. The Japanese central bank has been buying stocks since 2010 and long-term bonds under the Quantitative and Qualitative Easing (QQE) program since 2013.[17] It has set an explicit price target for long-term bond yields. In addition to broad-based quantitative easing, the ECB buys sovereign debt, and especially that of Italy, Spain, and Greece with sovereign debt problems, starting with the Public Sector Purchase Program (PSPP).[18] The ECB deliberately suppresses sovereign interest spreads, and has ended up with large portfolios of troubled sovereign debts. The ECB also buys "green bonds'' to raise their prices.[19]

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17 Kimie Harada & Tatsuyoshi Okimoto, *The BOJ's ETF Purchases and Its Effects on Nikkea 225 Stocks*, 77 INT'L REV. FIN. ANALYSIS (June 22, 2021), https://www.sciencedirect.com/science/article/pii/S1057521921001605.

18 *See* JOHN COCHRANE, ET. AL., REFORMING THE EURO: LESSONS FROM FOUR CRISES (2024).

19 The term "green bond" refers to debt securities issued by companies that meet certain environmental criteria. *ECB's Green Bonds Buying to Boost Eligible Issuers' Liquidity*, FITCHRATINGS (July 9, 2020), https://www.fitchratings.com/research/banks/ecb-green-bonds-buying-to-boost-eligible-issuers-liquidity-09-07-2020.

Attempting to raise asset prices to float the balance sheets of troubled financial institutions, forestall their failure, and stop a run of their creditors, has a long history (a history of bad ideas, to us, but a history nonetheless). For example, the original 2007 Troubled Asset Relief Program (TARP) enabled the US government to purchase "toxic" mortgage-backed securities to raise market prices of those securities and make banks that held them seem solvent.[20] The TARP ended up being used in other ways, perhaps recognizing the impracticality of the project, but the idea was there nonetheless.

The current motivation for price intervention has now expanded far beyond stemming runs and crises at financial institutions. Apparently, asking holders of long-term corporate bonds to sit through a transitory mark-to-market loss on the value of their portfolios is now a "systemic risk." Words like market "fragmentation" and "dysfunction" are used, especially at the ECB, to justify these price interventions. But if they mean anything, those are short-term effects. If they mean anything, at some point someone should ask why markets are perpetually "fragmented" or "dysfunctional," and why so little capital and liquidity is available to take advantage of occasional enormously profitable trading opportunities.

Over the summer of 2020, state, county, and city governments were having trouble borrowing. The Fed created the Municipal Liquidity Facility,[21] and bought newly-issued debt directly from state and local governments, in return for newly-created money. Ultimately, two borrowers—the State of Illinois and the New York Metropolitan Transit Authority (MTA)—borrowed $1.65 billion.[22]

Buying new debt directly from governments, in return for newly-created money, is an obvious temptation to inflationary finance via artificially high prices and low interest rates on the debt. Law and tradition have long kept the Fed from such direct purchases. Instead, issuers must face market prices, and the Fed must also buy on the market. When, as in the 2020 treasury markets, the Fed lends money to dealers to buy newly issued debt, and then buys most of the debt from the dealers a few days later, that separation is a bit of a fig leaf, but it is still a fig leaf. The fig leaf dropped.

The Treasury and Municipal lending programs broke new ground in another way. Traditionally, the Fed concerned itself with market prices of existing securities, and confined its operations to banks. It did not print money and lend it directly, financing new borrowing by people, governments, and businesses in the real economy. The Fed held to legal limits, by setting up Special Purpose Vehicles together with the Treasury, and lending to those

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20 *See generally Troubled Asset Relief Program: Lifetime Cost*, GOV'T ACCOUNTABILITY OFF. (Dec. 2023), https://www.gao.gov/assets/870/864482.pdf.

21 *Municipal Liquidity Facility*, BD. GOVS. OF THE FED. RSRV. SYS., https://www.federalreserve.gov/monetarypolicy/muni.htm (last visited Apr. 1, 2024).

22 Emily Munson, *$500 Billion Loan Fun for State Governments Barely Tapped*, MIDDLETOWN PRESS (Sept. 17, 2020), https://www.middletownpress.com/middletown/article/500-billion-loan-fund-for-state-governments-15576224.php.

vehicles, which then lent the money out. The government as a whole orchestrated the bailout.

That economic function expanded rapidly in a massive flow of government money to people and businesses, directly from the Treasury as well as via Fed programs. The "paycheck protection" program made forgivable loans to small businesses with 500 or fewer employees to cover their business costs, including mortgage interests, rent, utilities, and up to 8 weeks' payroll costs.[23] Other businesses got a generous "employee retention" tax credit.[24] Airlines were bailed out.[25] Individuals received various benefits such as "stimulus" checks, mortgage and student loan forbearance, generous and extended unemployment benefits, and extended Medicaid qualification.[26]

Perhaps sensitive to the charge in the 2008 crisis that the Fed saved "Wall Street but not Main Street," the Fed set up a "Main Street Lending Program"[27] in order to "support lending to small and medium-sized for profit businesses and nonprofit organizations."[28] "Loans issued under the Program have a five year maturity, deferral of principal payments for two years, and deferral of interest payments for one year."[29]

Overall, during the pandemic, the Fed created six such special purpose vehicles. In this way, the Fed lent on lenient terms to the real economy, not just the financial sector. Treasury programs added more support, both lending, forgivable loans, and transfers.[30]

This effort represented another large and unheralded loosening of our bailout regime. Previously bailouts focused on the financial system, and on preventing "crises," understood fairly narrowly as systemic runs at financial companies. The rationale for bailing out banks is that the interruption of banking business during widespread bankruptcy reorganizations will stop the flow of credit to the rest of the economy. Now, the large pandemic-era loans and payments in part represent support of the financial system. Giving people and businesses money allows them to pay loans on which they otherwise would have defaulted. The banks in the end got a lot of money, and bank creditors were again protected. But bailouts now extend much further than banks or even financial institutions, and their motivation is clearly to provide

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23 *What is the CARES Act?*, INVESTOPEDIA (Oct. 18, 2023), https://www.investopedia.com/coronavirus-aid-relief-and-economic-security-cares-act-4800707.

24 *Id.*

25 *Id.*

26 *Id.*

27 *Main Street Lending Program*, BD. GOVS. OF THE FED. RSRV. SYS., https://www.federalreserve.gov/monetarypolicy/mainstreetlending.htm (last visited Apr. 1, 2024).

28 *Id.*

29 *Id.*

30 Alicia Parlapiano, *Where $5 Trillion in Pandemic Stimulus Money Went*, N.Y. TIMES, (Mar. 11, 2022), https://www.nytimes.com/interactive/2022/03/11/us/how-covid-stimulus-money-was-spent.html; *see also Covid-19 Relief: Funding and Spending as of Jan. 31, 2023*, GOV'T ACCOUNTABILITY OFF. (Feb. 28, 2023), https://www.gao.gov/products/gao-23-106647.

direct support to people and businesses, in part forestalling bankruptcy reorganization, but not narrowly targeted even at that aim.

Throughout the economy leverage was rewarded and creditors protected. If you saved and bought a house with cash, if you saved and went to a cheaper college rather than take out a big student loan, or if you repaid that loan promptly, you did not get money. Airlines needed a bailout to avoid (another) bankruptcy because they had chosen debt-heavy financing rather than issue stock or retain earnings.

The consequent moral hazard now extends throughout the economy. Borrow. Borrow especially if you are big or part of a big and politically influential class of borrowers. As with student loans, borrow from the government. There is a good chance you will not have to pay it back.

One limitation is important: Most of the Fed's activity was conducted under its emergency powers, and did not turn in to permanent financing. Thus, the concern remains moral hazard during emergencies, not, yet, a permanent central bank-based credit system.

To be clear, our point is not to blame the Fed or the Treasury for these actions. There are no atheists in foxholes. A crisis is a terrible time to worry about moral hazard. In retrospect, some of the interventions, especially direct fiscal transfers, might have been overdone, but our central point is not centrally to call for restraint during a crisis. If a systemic run threatens, one has to bail out creditors. Bagehot's dictum calls for central banks to lend freely in a crisis, though the addenda of lending freely only at a penalty rate and only against good collateral are no longer followed.

Our complaint is that, despite the promises of Dodd-Frank, the system proved so fragile, so leveraged, so run-prone, so poor of available cash and liquidity, that the Fed and Treasury felt they had to take these actions again, and indeed to greatly expand the scope of bailouts.

Our complaint, also, is that while in 2008-2009 leaders at the Fed, Treasury, Financial regulators, and Congress had the decency to acknowledge something was wrong and needed fixing, nobody in a position of responsibility has acknowledged that anything is wrong with any of this, or that these actions build up a powder keg of moral hazard for the next time. They just pat themselves on the back for saving the world with a river of money, move on, and nobody has any concern that the same fragilities remain, are larger, and that the bailout will also have to be larger next time.

POST-COVID BAILOUTS

Covid was the first shock. Rising interest rates to contain the inflation induced by the Covid fiscal blowout provided the second shock.[31] The failure

[31] On the fiscal roots of the 2021-2023 inflation, see JOHN COCHRANE, THE FISCAL THEORY OF PRICE LEVEL (2023); John H. Cochrane, *Fiscal Narratives for US Inflation*, GRUMPY ECON. (Jan. 4. 2024), https://www.grumpy-economist.com/p/fiscal-narratives-for-us-inflation.

of the basic regulatory regime—bailouts plus regulatory risk management—is even more evident in this case.

The failures of Silicon Valley, Signature, and First Republic banks in early 2023 are the most salient events. Inflation started to surge in February 2021. In the second quarter of 2022, PCE deflator inflation, the Fed's favorite measure, reached 6.8%. The Fed so far had not budged interest rates above essentially zero, a slower reaction to inflation than even in the 1970s. The possibility that interest rates might rise seems at least like a risk one ought to consider. Rise they did. Starting with a 0.25% rise in late March 2022, the Federal Funds rate rose slowly to 4.33% by January 2023, eventually rising to 5.33% by August 2023.

Meanwhile, Silicon Valley Bank took in a large amount of uninsured large deposits. It turned around and invested that money in long-term treasury and guaranteed agency securities, betting that short-term rates would not rise. No subprime mortgages, no CLOs, no toxic derivatives, no hard-to-understand special vehicles. Its only risk was that higher interest rates would lower the market value of its assets and raise the rate it would have to pay on its borrowing, a risk understood at least since the 1700s. Interest rates rose, the market value of assets plunged. Large depositors ran quickly, a fact made easier by social media and electronic banking.

The Federal Deposit Insurance Corporation (FDIC) reacted by guaranteeing all deposits, of any size.[32] This is not official going forward, but there is no action to even promise "never again," so effectively markets expect all deposits of any size to be guaranteed going forward, at least during any newsworthy event. The cycle of guaranteeing more debts in each crisis continues, though so far without the decency of an investigation what went wrong and promise to do anything about the moral hazard. Via a new Bank Term Funding Program,[33] the Fed provided one-year loans to banks secured by U.S. Treasury securities, *valued at par,* not at lower market values. One year later, the Wall Street Journal reported, "banks are gaming it" to make near-arbitrage profits.[34] The government orchestrated the big banks to make large deposits to First Republic to prop it up, an interesting observation on its power to force too-big-to-fail banks to make bad investments.

The runs caused headlines, but the risk-management failure is widespread. Jiang, Matvos, Piskorski, and Seru estimate that a large fraction of commercial banks lost nearly all the market value of their equity due to

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32 Press Release, Fed. Rsrv., Joint Statement by Treasury, Federal Reserve, and FDIC (Mar. 12, 2023), https://www.federalreserve.gov/newsevents/pressreleases/monetary20230312b.htm.

33 Press Release, Fed. Rsrv., Federal Reserve Board Announces It Will Make Available Additional Funding to Eligible Depository Institutions to Help Assure Banks Have the Ability to Meet the Needs of All Their Depositors (Mar. 12, 2023), https://www.federalreserve.gov/newsevents/pressreleases/monetary20230312a.htm.

34 David Benoit & Eric Wallerstein, *The Fed Launched a Bank Rescue Program Last Year. Now, Banks Are Gaming It.*, WALL ST. J. (Jan. 10, 2024), https://www.wsj.com/finance/banking/the-fed-launched-a-bank-rescue-program-last-year-now-banks-are-gaming-it-43e9cee3.

interest rate risk.[35] Hedging interest rate risk via swaps is kindergarten banking, but very few banks did any such hedging. They were consciously betting on further rate declines, and salvation in case of trouble.

Where were the regulators? With hundreds of thousands of Dodd-Frank rules, with layers of federal and state regulators, how could a regulatory architecture that promises to monitor and contain risk miss such simple maturity mismatch?

One answer is subtle. Banks are allowed to value long-term assets at book value, in "hold to maturity" accounting. There is no current rule connecting large uninsured run-prone deposits to interest rate risk in hold-to-maturity assets. As simple, glaring and obvious as the hole in SVB's balance sheet is, there actually was no rule against it.

Rules have a paradoxical flaw. Suppose a regulator were to say "I took the first week of undergraduate banking. I see old fashioned interest rate risk on your balance sheet. Interest rates could rise, the value of your assets could fall, and uninsured depositors could run. Do something about it." The bank has a plausible response: "We ticked all the boxes, complied with all the rules, get out of my office." Lehman brothers had all required regulatory capital the day it went under.

That story however was not the case. SVB's regulators were aware of the problem, and had been aware for months. But they took no decisive action. At the time of SVB's failure in March 2023, supervisors were still drafting an enforcement action, the Memorandum of Understanding against the bank stemming from deficiencies identified over seven months prior.[36]

Higher-level regulators do seem to have been oblivious to the elephant in the room. While the monetary policy arm of the Fed was loudly saying that interest rates were going to go up, and while six percent inflation against zero percent interest rates made that event more and more likely, the Fed's own stress tests in Fall 2022 asked banks only to evaluate their risks in a scenario of falling interest rates and recession, i.e., what if 2008 happens again. Stress test scenarios are discretionary and not bound by rules. The generals preparing for the last war analogy is apt. The left hand apparently does not talk to the right hand. Indeed, much opinion in and around the Fed seems to think that separating monetary policy from financial regulation is a good thing.

There are reasons that the SVB run was a bit of a surprise. Statistical risk modeling suggested that deposits are "sticky," that people will keep money deposited at banks, not even demanding higher interest rates in an environment of rising rates and falling asset values, let alone run based on

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35 Erica Xuewei Jiang, et. al., *Monetary Tightening and U.S. Bank Fragility in 2023: Mark-to-Market Losses and Uninsured Depositor Runs?* (Nat'l Bureau of Econ. Rsch., Working Paper No. w31048, 2023), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4387676.

36 Michael Barr, *Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank,* BD. GOVS. OF THE FED. RSRV. SYS., at 8 (Apr. 28, 2023), https://www.federalreserve.gov/publications/review-of-the-federal-reserves-supervision-and-regulation-of-silicon-valley-bank.htm.

accounting numbers that few depositors pay attention to. Banks did not routinely hedge interest rate risk and were allowed by regulators to value long-term bonds at fictitious prices, in large part based on this experience. If that statistical habit persisted, then deposits would act like low-interest long-term debt, and banks would not in fact be exposed to interest-rate risk. Moreover, runs used to take time, as people lined up at the bank, Jimmy Stuart style. Few regulators or bankers realized that social media and electronic banking could change all that. And SVB and the others were unusual in relying on large uninsured deposits, where the statistical experience of "sticky" deposits came from small insured deposits. Beware applying statistical models outside their domain.

Still, it is not as if this event was unique in history. Continental Illinois had a run of uninsured deposits in 1984.[37] The Savings and Loan fiasco of the 1980s, together with the flight of deposits from banks to money market funds, which undermined the previous regulatory architecture, was sparked by the last large rise in interest rates in response to inflation.[38] Statistical risk modeling fell apart in 2008. This is not ancient history. Institutional memory ought to last this long.

The April 28, 2023, report and letter from Fed Vice Chair Michael Barr recognizes that "Federal Reserve supervisors failed to take forceful enough action" and, commendably, that "strong bank capital matters," but the 98 page report doesn't really come to firm conclusions, especially given the simple and transparent nature of SVB's failure.[39] In January 2024, the Comptroller of the Currency, Michael Hsu, was reportedly readying a proposal for the next obvious step in the regulate, fail, and regulate some more dance: Add rules.[40] Recognizing that uninsured deposits can flee faster than previous rules envisioned, one is sympathetic, but shouldn't this elephant in the room have been visible ahead of time? Is this 100,001th rule going to finally stop the dance? Hsu also proposes more widespread discount window borrowing, a useful improvement in general.

The hard lesson is that, despite thousands of well-trained economists, a regulatory machine cannot think out of the box, to the point of recognizing that statistical correlations can fall quickly to a tide of elementary rational behavior. The machine cannot remember and apply very simple lessons of

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37 Lee Davison, *Chapter 7: Continental Illinois and "Too Big to Fail"*, *in* FED. DEPOSIT INS. CORP., HISTORY OF THE EIGHTIES: LESSONS FOR THE FUTURE. VOL. 1, AN EXAMINATION OF THE BANKING CRISES OF THE 1980S AND EARLY 1990S 235–58, https://www.fdic.gov/bank/historical/history/235_258.pdf.

38 *Savings and Loan Crisis*, FED. RSRV. HISTORY, https://www.federalreservehistory.org/essays/savings-and-loan-crisis (last visited Apr. 1, 2024).

39 Barr, *supra* note 36.

40 Gina Heeb, *'The Bank Runs are Faster Now': Regulator Calls for Stricter Rules on Flighty Deposits*, WALL ST. J. (Jan. 18, 2023), https://www.wsj.com/livecoverage/stock-market-today-dow-jones-earnings-01-18-2024/card/exclusive-top-bank-regulator-to-call-for-new-liquidity-rules-4ZfWN1jwTYcB7hUxrTa6.

first-week banking classes and a slightly longer historical experience. Graham Allison's lesson that you can't ask bureaucracies to think or execute anything novel rings true.[41]

Our point is not the failure of people, who could do better from simply yelling a bit louder, but the essential failure of a regulatory architecture, which simply cannot do the tasks we wish it to do, no matter how good the people involved or how much one tries to expand the regulatory rule book to cover every possible contingency.

UK regulators failed to recognize plain vanilla interest rate risk in a similar manner.[42] In September 2022, UK pension funds melted down. UK pension funds are required to hold long-term securities, usually long-term government bonds, to match their long-term liabilities. That requirement was a useful innovation. Believing long rates would stay above short rates and all rates would fall, many of the pension funds doubled up, borrowing short term to hold even more long-term bonds. For many years, this strategy was profitable as interest rates continued to decline, and allowed the funds to make up some of their under-funding. But if any financial company is making a lot of money, wise regulators should be alerted that risk taking rather than genius is usually involved, and that risk can turn around. That is an uncommon attitude.

When interest rates finally rose in 2022, the pension funds suffered huge losses. An apparently small rise from 1% to 2% on a long-term interest rate can imply 30% or more decline in value. Moreover, the pension funds had to post collateral against their borrowing. They tried to bail out of positions to raise cash and prevent more losses, selling long-term securities en masse, further driving down prices and up rates. Observers were treated to the interesting combination of quantitative tightening—the Bank of England selling long-term bonds for inflation control—together with quantitative easing—buying long-term bonds for financial "stability" control, i.e., to prop up the value of long-term bonds and hence pension fund portfolios.

This event should have been even easier to foresee, as it did not involve any mystery about when depositors might run. Making a big bet and selling in a panic to make margin calls when prices go the other way is as old a way to fail as financial markets.

In March 2023, Credit Suisse was in danger. After years of trouble, big depositors were leaving. Finally, the event we've been waiting for since 2008 came about. A big bank was teetering. There was a chance to use all the post-crisis big-bank reforms. No. Instead, the Swiss government orchestrated a weekend sale to UBS, with a substantial infusion of Swiss government money. This was the standard pre-Lehman, pre-Dodd-Frank, pre-Basel procedure, for example with Bear Stearns. What happened to no more too big to

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41 GRAHAM T ALLISON, ESSENCE OF DECISION; EXPLAINING THE CUBAN MISSILE CRISIS (1971).

42 *See* Ketan B. Patel & Santiago I Sordo Palacios, *UK Pension Market Stress in 2022—Why It Happened and Implications for the U.S. Chicago*, FED. RSRV. BANK OF CHI. (June 2023), https://www.chicagofed.org/publications/chicago-fed-letter/2023/480.

fail, creditor bail-ins, living wills, orderly resolution, orderly restructuring in which equity loses before convertible debt is triggered? What happened to the central promise of big bank financial regulation? Evidently, the Swiss authorities felt that the whole machine was unworkable.

Lengwiler and Weder di Mauro report that Swiss authorities considered several options:

> 1. A resolution of Credit Suisse, declaring the point of non-viability and triggering the bail-in and conversion of bail-inable bonds (about CHF 48 billion). This would have followed the script of the resolution plan.
>
> 2. A temporary public sector ownership. This is not foreseen in the Swiss TBTF regime and would have required emergency law.
>
> 3. A merger of Credit Suisse with UBS.[43]

In the end, the merger was considered the least risky option.

The merger came with substantial public sweeteners, and bailouts of some creditors but not others:

> UBS offered $3 billion to acquire Credit Suisse with additional public support. Credit Suisse's AT1 bonds (CHF 16 billion) were wiped out, since they contained a clause which allowed for a full write-down if public support was provided. . . .
>
> The public support package consisted of liquidity assistance totalling CHF 250 billion from the SNB. CHF 100 billion was backed by a federal default guarantee. . . .
>
> the federal government [also] assumed a loss guarantee capped at CHF 9 billion.[44]

After the fact the government "earned about CHF 200 million" on the guarantee, but making money ex-post does not mean expensive risk was not assumed ex-ante.[45]

Noteworthily, "Credit Suisse… comfortably [met] all regulatory capital and liquidity requirements,"[46] just as Lehman Brothers did. So much for those thousands of pages, too. Again, the regulatory apparatus is apparently unable to signal trouble let alone to prevent it.

This is a stunning event. All the architecture that promised an end to too big to fail—too big for equity holders even to be wiped out, too big for regular precedents of creditors, too big for resolution—is apparently useless. The choice is especially noteworthy since Credit Suisse was clearly an

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[43] Yvan Lengwiler & Beatrice Weder Di Mauro, *Global Lessons from the Demise of Credit Suisse,* VOX EU CEPR (Sept. 4, 2023), https://cepr.org/voxeu/columns/global-lessons-demise-credit-suisse.

[44] *Id.*

[45] *Id.*

[46] *Id.*

isolated event with unique problems. Unlike the case in 2008, nobody suspected its problems extended to other banks. There was no systemic run, no cascade of other banks likely to fail, no "contagion," no likelihood of a systemic run should resolution plans be practiced.

Lengwiler and Weder di Mauro opine that, "the fact that the restructuring option was not chosen in the case of Credit Suisse does not mean that resolution planning had failed. In fact, the authorities emphasize that the bail-in would in principle have been possible."[47] Further, they opined that, "*The main lesson is that the TBTF regime is not broken*."[48]

An expert group containing both Lengwiler and Di Mauro further noted that, in their view, the Swiss government chose a sweetened merger as it "entailed fewer execution risks."[49] Well, yes, but that's the whole issue, no? If after 15 years, with lots of warning, an isolated bank can't be resolved according to plan because of "execution risks," the whole plan is pretty rotten.

We come to the opposite conclusion, the same as many Dodd-Frank/Basel critics including ourselves had at the outset. This plan will never be used.

Lengwiler and Weder di Mauro note a minor paradox, there is only one large Swiss bank left, so the merger option is now off the table "if ever UBS was in an existential crisis." Good luck.

Many US banks are, as of January 2024, in an "extend and pretend" regime. They are sitting on unrealized commercial real estate (CRE) losses as well as unrealized losses in long-term bond portfolios.[50] The Fed's November 2023 Supervision Report indicates that supervisors are monitoring CRE exposures: "Recent efforts include a horizontal review to address exposures to potential deterioration in CRE markets. Supervisors are centering the review on evaluating credit risk monitoring and measurement, internal loan risk rating accuracy, steps taken to mitigate the risk of losses on CRE loans, and CRE risk reporting to firms' boards of directors and senior management."[51] However, supervisors have not historically responded quickly to bank risk-management deficiencies.

The Federal Home Loan Bank (FHLB), a government-sponsored entity created to support the housing market during the Great Depression, is now a

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47 *Id.* For a view of potential reforms to the Swiss TBTF system, see Yvan Lengwiler, et. al., *The Need for Reform After the Demise of Credit Suisse*, RPT. OF THE EXPERT GRP. ON BANKING STABILITY (Sept. 1, 2023), https://too-big-to-fail.ch/en_US/report.

48 Lengwiler & Di Mauro, *supra* note 43 (emphasis in original).

49 Lengwiler, et. al., *supra* note 47, at 18.

50 Erica Xuewei Jiang, et. al., *Monetary Tightening, Commercial Real Estate Distress, and US Bank Fragility* (Nat'l Bureau of Econ. Rsch., Working Paper No. w 31970, 2023), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4413799.

51 *Supervision and Regulation Report*, BD. GOVS. OF THE FED. RSRV. SYS. (Nov. 2023), https://www.federalreserve.gov/publications/files/202311-supervision-and-regulation-report.pdf.

source of subsidized loans for all banks.[52] As deposits fled the banking system in end March 2023, the FHLB extended more than $800 billion in loans to banks in the second quarter of 2023 alone.[53] Whether these loans from what is clearly another "lender of last resort" were made to insolvent banks remains unknown. That Silicon Valley Bank borrowed heavily from FHLB in the days before its failure—i.e., when it was clearly insolvent—does not lend a lot of confidence that banks being supported are plausibly solvent rather than zombies, as lender-of-last-resort doctrine requires.[54]

SYSTEMIC FAILURES AND SYSTEMIC REPAIR

Our Fed, and financial regulatory architecture in general, has suffered a massive institutional failure. The central promise of the Dodd-Frank regulatory expansion is shown to be empty. The 2020 bailouts were larger than 2008, both in dollars and in scope. Expansion plans, such as the "macro-prudential" project that central banks would artfully spot and counter the "credit cycle" by tightening regulations on the upside and loosening on the downside, unlike the universal contrary historical habit, should seem utterly fanciful.

By "institutional" we explicitly do not place blame on individuals. The people are smart, knowledgeable, and well-meaning. The system is broken.

After major institutional failures, there is usually a period of soul searching, an inquest, at least a research project devoted to what went wrong and how can we fix it, a concerted attempt to understand the pervasive moral hazard that bailouts have engendered and how, finally, to contain it. Astonishingly, nothing of the sort is happening regarding the 2020 bailouts. The SVB and Credit Suisse failures seem destined to produce only a little muttering and an expansion of the rule book, but no mention of moral hazard repair. If nothing else, we hope to spark that conversation.

The natural response will be to add more rules and regulators. But this was not a case of ever more complex, devious, or unexpected structures failing. Even the simplest markets and institutions—the treasury market, money market funds, interest rate risks—failed. That failure says clearly, we do not need another hundred thousand rules.

Instead, the central approach of allowing a fragile and highly leveraged financial system, providing bailouts that incentivize that fragility, but counting on regulators to spot and contain risk is fundamentally doomed. If the

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52 *See generally Federal Home Loan Banking System*, FED. DEPOSIT INS. CORP., https://www.fdic.gov/resources/bankers/affordable-mortgage-lending-center/guide/part-3-docs/federal-home-loan-bank-system.pdf (last visited Apr. 1, 2024).

53 *The Role of Federal Home Loan Banks in the Financial System*, CONG. BUDGET OFF. (Mar, 2024), https://www.cbo.gov/publication/60064.

54 *See* Aaron Klein, *SVB's Collapse Exposes the Fed's Massive Failure to See the Bank's Warning Signs*, BROOKINGS (Mar. 16, 2023), https://www.brookings.edu/articles/svbs-collapse-exposes-the-feds-massive-failure-to-see-the-banks-warning-signs.

regulatory system can't see plain vanilla interest rate risk connecting deposits and long-term Treasurys, what hope is there that risk regulators will see the next Credit Suisse—which also met all its regulatory checkboxes?

Why not just give in? The government and the Fed saved the world again with a river of money, apparently easily. Give them a pat on the back, get used to the bailout regime, and wait for them to save the world the same way next time. That's where we're headed, for sure. Why not?

Surely, private gain in good times, taxpayers bear losses in bad times, may offend a bit.

A larger practical problem is that the ever-expanding bailout loop cannot go on. Bailouts require resources. Those resources come from issuing debt or printing money, which ultimately means future taxes or inflation. Everything is finite, including the US government's ability to borrow real resources in a crisis.

We have already seen limited fiscal capacity in the last episode. Investors sold, not bought, Treasurys. Interest rates would have risen a good deal more if the Fed had not monetized much of the debt. Most of all, the bailout and stimulus clearly led to a bout of inflation. Somebody has to pay for the $5 trillion of resources transferred during the pandemic. If it is not future taxpayers, it is the holders of outstanding nominal bonds. Unexpected inflation ate away about 15% of the value of their bonds, the equivalent of a default with a 15% haircut. We have seen the limits of the US borrowing capacity. Those investors might be more leery of holding bonds next time.

In the next crisis, the US fiscal situation and ability to raise immense bailout funds will be further stressed. The CBO's 2023 long-term budget projections show steady 5-8% of GDP primary deficits forever, and exploding debt.[55] And those projections are optimistic. They assume that nothing goes wrong: no crisis, recession, pandemic, war, or spending increase. This debt path simply cannot happen, and a major fiscal reform must take place. In the meantime, however, our government's ability to borrow another $5 trillion, or maybe $10 trillion, which requires persuading investors that this much additional fiscal surplus will eventually be provided to repay debt, is ever more in doubt.

Beyond scheduled and discretionary expenses, our government guarantees a lot of debt. Fannie and Freddie are unreformed, another broken promise of the Dodd-Frank era. Even in 2007, the agencies only bought, guaranteed, and securitized 65% of mortgages.[56] Now, they and other government agencies have a much larger market share.[57] Private securitization is crushed.

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55 *The 2023 Long – Term Budget Outlook*, CONG. BUDGET OFF. (Jun. 2023), https://www.cbo.gov/publication/59331.

56 Norbet J. Michel, *Overreliance on Fannie and Freddie Violates Their Federal Charters*, HERITAGE FOUND. (May 12, 2021), https://www.heritage.org/markets-and-finance/commentary/overreliance-fannie-and-freddie-violates-their-federal-charters.

57 *Fannie Mae & Freddie Mac (GSEs)*, NAT'L ASS'N REALTORS, https://www.nar.realtor/fannie-mae-freddie-mac-gses (last visited Apr. 1, 2024).

Banks and fintech hold little debt on their books, mostly originating mortgages to distribute, with government guarantee. Fannie and Freddie are also lent to mortgage services providers to cover their losses under forbearance in 2020.

In student loans, in mortgage forbearance (CARES act), in rent forbearance, it seems impossible for our democratic government to lend money to its citizens and demand repayment, especially in bad times. But of course bad times are just when money may be tight for the government.

To be concrete, imagine that at some point in the next few years China invades or blockades Taiwan. Pacific trade comes to a halt. Financial sanctions embroil industry. We have a huge financial and economic crisis on our hands. And everyone is, as usual, levered up. The US will respond, as usual, with trillions of bailout, stimulus, and forbearance. The US may want to borrow, say $10 trillion, in addition to rolling over maturing debt, and this time borrowing a lot of money to finance military expenditures as well. Will markets provide that much new saving? Or will this borrowing result in rather instant inflation, rising credit spreads, and will the government be forced to dramatically cut back? Will the financial fire house have burned down? A new pandemic, a middle east war, a nuclear weapon going off somewhere, and many other easily conceivable events could provoke the same crisis. We have once in a century crises every 10 years these days.

Even before the next crisis, central banks may be constrained. Yes, inflation has eased, and interest rates may be heading down. If so, "extend and pretend" may work out, at least for interest rate risk. But inflation may resurge. This could be 1976, not 1982. If so, central banks will be in a quandary. Inflation control requires higher interest rates, but the still-leveraged, still-unhedged financial system may not withstand higher interest rates. Another round of 2020-2021 bailouts, but larger, could well lead to another round of 2021-2023 inflation, but larger, requiring higher interest rates still.

Higher interest rates also raise debt service costs. At 100% debt/GDP, each percentage point higher interest rates is 1% of GDP higher deficit, adding fiscal fuel to the inflation fire. The ECB faces a double challenge: Higher interest rates especially raise debt service costs for perilous sovereigns such as Italy, whose bonds the ECB owns in abundance and whose spreads the ECB is expected to contain in what it regards as a financial stability measure.

Our main concern is incentives. Bailouts stop crises after the fact, and perhaps democratically elected governments can be sufficient stewards of taxpayer money to balance the cost to taxpayers of occasional bailouts. But bailouts, price supports, and other measures give financial market participants incentives to borrow too much, to leave too little cash around, and thus to rely on larger and larger bailouts. We need to constrain those incentives. The regulatory architecture epitomized by the Dodd-Frank and Basel apparatus tried to do so. It failed. We need a substitute, not to just give up.

THE WAY OUT

Fortunately, there is a straightforward way out. We can construct a financial system that is immune from private sector financial crises and hence the need for bailouts. It can be as or more innovative and functional as the current one, giving savers ample returns and borrowers ample access to credit and investment capital. The blueprint has been around[58] since the 1930s. Arguably, modern information, communication, and financial technology makes it even more easily achieved than when first conceived.

First, we must restore clarity on just what "financial stability" means, and what events are, genuinely, in need of a regulatory response. "Financial stability" has come to mean the possibility that someone, somewhere, might lose money, even just on a mark to market basis, that an interest rate might rise, a price might fall. It has come to mean some business somewhere might undergo bankruptcy reorganization, or an individual bank might experience a run.

No. A financial crisis is a systemic run, when people run to get cash out of short-term promises all over the financial system, including healthy institutions, and the capacity of the financial system to function is imperiled. This is what happened in 2008. Other events are not crises.

Likewise, "contagion" has become overused, a dark yet vague fear that somehow any ripple anywhere might bring down the financial system. To laypeople it sounds like a technical term, but it has evolved to no meaning beyond this vaguely stated fear. Contagion requires a mechanism. If there is a run at one bank due to losses in one particular kind of security, other banks with similar exposure might suffer runs. That's a sensible "contagion," though propping up the first bank might do little to stop such a run at the second. But if other banks do not have similar exposures, and that is well known, such "contagion" will not happen. Central bankers spoke of "contagion" from Greece to Italy. Why? Italy did not own any Greek debt. At best we learn from a Greek default whether or not the rest of the EU will bail out Italy, but that is not the usual meaning of the word. We should only use the word "contagion" along with an explicit mechanism.

With this understanding, it is possible to pre-commit against many bailouts.

But other bailouts loom for good reason. Once a run is underway, a creditor bailout is really the only way to stop it, and governments will (and must) stop it. Bailouts are not really bailouts of the bank or other institution in the news, but rather bailouts of their creditors. Short-term creditors are running to get their money out while they can. The government guarantees the value of short-term debts to stop creditors from running. Whether the government props up the market value of failing institutions' assets, buys or

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58 We refer to the "Chicago Plan" advocated by a group of economists in the 1930s in various publications.

lends against assets at inflated prices, arranges a sale of the failing institution to a solvent purchaser who will honor debts, with some guarantees and sweeteners, "injects" equity, or directly guarantees liabilities such as deposits, the effect is the same: Short-term creditors get their money back in full and can stop running.

But protection leads to too much risk taking by investors and by bankers. So in our sequence of financial crises, over and over again, authorities bailed out creditors to stop a run and then passed regulations to try to constrain risk taking so another larger crisis would not break out. The Dodd-Frank and Basel approaches were not anything new, they were just the latest in a centuries-long cycle.

Events since 2020 do not break this history by its bailout. They break this history by the unusual lack of any interest in containing moral hazard so the next one is not larger.

How can we escape the treadmill? The ingredients are simple, First, risky financial investing, like risky corporate investing, must be financed by equity and long-term debt which are securities that cannot run. When a stock-financed company loses money, you can't run to get your money out and bankrupt the company when it can't pay you. The price goes down instead. Second, any run-prone securities such as deposits must be fully backed by interest-paying reserves or short-term treasury debt.

Equity-financed banking and narrow deposit-taking (we avoid the word "narrow banking" on purpose) is well described elsewhere,[59] as are clear responses to all the standard objections. No, borrowers will not be starved for credit. They can get as much as now, and at good rates. The converse is one of the most persistent fallacies surrounding equity. Jay Powell himself, said of a two-percentage point capital increase "raising capital requirements also increases the cost of, and reduces access to, credit."[60]

This is simply not true, as Admati and Hellwig and many others have proved time and again.[61] Additional equity has no social cost, and indeed has a social benefit. It carries a big private cost to banks and their current shareholders, which lose too-big-to-fail bailouts and guarantees courtesy of taxpayers. Banks predictably decry any attempt to raise capital, and are persuasive to regulators as well.

A common confusion is revealed when people say banks "hold" capital. Banks "hold" reserves, liquid assets or cash, and those reserves are not lent

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59 *See, e.g.*, ANAT ADMATI & MARTIN HELLWIG, THE BANKERS' NEW CLOTHES: WHAT'S WRONG WITH BANKING AND WHAT TO DO ABOUT IT (2024); John H. Cochrane, *Toward a Run-Free Financial System*, *in* ACROSS THE GREAT DIVIDE: NEW PERSPECTIVES ON THE FINANCIAL CRISIS (Martin Neil Baily & John B. Taylor, eds., 2014), https://www.johnhcochrane.com/research-all/toward-a-run-free-financial-system; Peter DeMarzo, et al., *Resolving the Banking Crisis: A Proposal*, available at https://gsb-faculty.stanford.edu/amit-seru/ (last revised Apr. 12, 2023).

60 Jerome Powell, Joint Press Release, Statement by Chair Jerome H. Powell, BD. GOVS. OF THE FED. RSRV. SYS. (July 27, 2023), https://www.federalreserve.gov/newsevents/pressreleases/powell-statement-20230727.htm.

61 *See generally* ADMATI & HELLWIG, *supra* note 59.

out. Banks issue equity capital, or build up the value of equity capital via retained earnings. Capital is a source of funds, not a use of funds, it's a place banks get money to lend, not a sink for funds that would otherwise be lent.

No, investors will not face an insurmountable rationing of necessary cash. An equity-financed banking and narrow deposit-taking system can provide as much money as people want to hold. And, today, assets that bear some price risk can be just as liquid as money, obviating the need for immense cash holdings. "Narrow deposit takers" are essentially money market funds with enhanced transactions services, a familiar product, not a crazy new idea that opens the door to financial collapse.

We have seen the benefits of an abundant-reserves regime, in which banks no longer scramble to just meet reserve requirements, and in which reserve requirements no longer constrain bank lending and deposit creation. We need a parallel abundant-equity regime. For example, the turbulence in Treasury markets in 2020, in which dealer banks refused arbitrage opportunities, has been chalked up to the fact that they were up against capital budgets, and, crucially, they were not willing to get more capital even to finance arbitrage opportunities. The debt overhang keeping banks right at capital constraints disappears when capital is abundant.

The Federal Reserve and international banking regulators are now finalizing a "Basel III endgame" proposal to strengthen big-bank regulation.[62] It's a large and complex proposal. Most of it is a long addition to the hundreds of thousands of rules we have now, adding to risk assessment rules that just failed so miserably at SVB and Credit Suisse. David Wessel writes perceptively, "The proposal fills 316 pages of small type in the Federal Register . . . Few people besides regulators, executives of banks that would be affected, and their lawyers understand the details."[63]

The headline 16-percent increase in capital sounds like a lot, but 16 percent is only 2 percentage points, since capital is so low already. Abundant capital requires 20 or even 50 percentage points more capital.[64] How much, exactly? So much that the precise number doesn't matter, because banks will never fail.

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[62] *See* Joint Press Release Agencies Request Comment on Proposed Rules to Strengthen Capital Requirements for Large Banks, BD. GOVS. OF THE FED. RSRV. SYS. (July 27, 2023), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230727a.htm.

[63] David Wessell, *What is Bank Capital? What is the Basel III Endgame?*, BROOKINGS INST. (Nov. 29, 2023) https://www.brookings.edu/articles/what-is-bank-capital-what-is-the-basel-iii-endgame.

[64] There is evidence that banking activities can be accomplished with much higher capital. Erica Xuewei Jiang, et. Al., Banking Without Deposits: Evidence from Shadow Bank Call Reports (Nat'l Bureau of Econ. Rsch., Working Paper No. w 26903, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3584191. Compare financial leverage of banks with non-banks engaged in similar lending activities. Non-banks operate under a less restrictive regulatory framework but lack access to insured deposit funding. They find that non-banks voluntarily maintain more than twice as high equity capital than banks, with the most significant disparity observed among smaller and mid-size banks that exhibit much higher financial leverage compared to their unregulated counterparts without access to deposit funding.

How do we get there? We need not reform the current giants, or rewrite the current rule book, taking another 15 years (from Dodd-Frank to Basel III). It would suffice to simply get out of the way, to allow equity-financed banking and narrow deposit taking to emerge, with the light regulatory touch such run-free institutions require, and let the flowers bloom. If the market value of equity and long-term debt is more than, say, 80 percent of the value of liabilities, the financial institution needs no asset regulation and can do what it wants, regulated no more than any other company. If a bank instead wishes today's capital structure, it faces today's regulations. A simple regulatory tax on short-term debt financing can also gently provide a nudge.

The Federal Reserve, which has been on a legal warpath against narrow deposit takers, could simply follow its legal mandate and allow them. A gold star for "can't possibly cause a run" would be nice too, instead of the current silly claim that allowing this enhanced form of money market fund would spark runs elsewhere.[65]

Simply allowing equity and long-term debt financed investment companies and narrow deposit takers and transactions service providers to operate would allow them to expand.

The absence of government guarantees would also have a salutary effect on financial stability. Your fire sale is my buying opportunity. There is little incentive now to hold some cash aside, as the Fed will jump in during any bad time and outbid you. When prices can fall without fear of a systemic run, then there will be lots more private capital available to jump in and make sure prices don't fall.

Naturally, it would also be a financial system in which new innovative entrants can come, and old dysfunctional businesses can go.

Standing in the way, of course, is a vast armada of financial institutions that profit from the current game, that have invested hundreds of millions in regulatory compliance/barriers to entry, and that profit from risk taking in good times knowing they will be protected in bad times, along with a lot of obfuscation from financial market analysts.

Also the regulators, whose livelihood depends on deep human capital of the current system, their relationship to a financial industry, and their presumption of technocratic competence to manage even tiny details of the financial system will surely not be pleased at such a fundamental reform. Capture goes both ways. Their ability to tell financial firms where to invest will collapse as well.

But this is politics, not finance. If we could just get to the point of agreeing that there is a problem, that the current system will collapse, that there is a clear solution, and all that stands in the way are vested interests, then we would have made a lot of progress.

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[65] *See* Letter from James McAndrews, CEO of TNB USA Inc., to Jerome Powell, Chairman of the Bd. of Govs. of the Fed. Rsrv. Sys., Appealing Account Application Denial (Feb. 26, 2024), https://www.tnbusa.com/wp-content/uploads/2024/02/TNB-Letter-of-Appeal.pdf.

APPENDIX. A BRIEF HISTORY OF BAILOUTS

Continental Illinois' failure in 1984 spawned the term "too big to fail." The bank lost a lot of money on bad loans and a run developed. The FDIC seized the bank. Notably, the government chose to bail out large uninsured depositors and bondholders, who had no formal ex-ante protection.[66]

In an interesting precedent for 2023, many Savings and Loans failed as interest rates rose in the early 1980s to combat inflation. They had invested in fixed-rate mortgages and other low-yielding assets. Financial innovations, including interest-bearing checking accounts and brokered deposits, along with deliberate regulatory "forbearance" in the hope that S&L could grow out of problems, allowed S&Ls to take on extra risks with guaranteed deposits, and losses grew. From a 1983 estimate that it would take $25 billion to pay the depositors of failed S&Ls, by 1986, almost 1,000 operating S&Ls were insolvent or nearly insolvent and, in the end, according to the Fed it cost about $124 billion to settle all S&Ls in trouble. Congress responded with the Financial Institutions Reform, Recovery and Enforcement Act of 1989. The Federal Home Loan Bank Board was abolished and was replaced by the Office of Thrift Supervision. S&Ls insurance was established under the FDIC. The Resolution Trust Corporation (RTC) was initiated to deal with the remaining problematic S&Ls.[67]

Latin American countries had trouble repaying sovereign debts in the 1980s. US commercial banks holding debt from troubled Latin American countries were allowed to delay the recognition of their losses to maintain solvency or the appearance of solvency, and thus to protect the banks' depositors and creditors. Private lenders in the US to the same countries had to forgive $61 billion of their lending. The US acted as the lender of last resort by organizing a collective rescue among the International Monetary Fund (IMF), central banks, and commercial banks. The IMF agreed to lend to countries in trouble, helping them pay the loans' interest, in return for promises to shift their economies towards free-market policies and cut public expenditures. Even the Fed's official history notes, "allowing those institutions to delay the recognition of losses set a precedent that may have weakened market discipline and encouraged excess risk-taking in subsequent decades."[68]

To deal with the 1997 East Asian crisis, and the danger that banks, which lent to those countries might fail, the IMF, the World Bank, the Asian Development Banks, and several governments offered $118 billion in loans to Thailand, Indonesia, and South Korea. Led by the New York Fed, US

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[66] Davison, *supra* note 37, at 235–58.

[67] *See Savings and Loan Crisis*, *supra* note 38.

[68] *Latin American Debt Crisis of the 1980s*, FED. RSRV. HISTORY, https://www.federalreservehistory.org/essays/latin-american-debt-crisis (last visited Apr. 1, 2024).

commercial banks also agreed to roll over some short-term loans owed by South Korea and restructure them as medium-term loans. The aid included policy conditions for the countries, including decreasing their bank's leverage and tightening fiscal policies. They voluntarily chose much larger foreign exchange reserves and capital controls on the idea that governments should stop "hot money."[69]

In 1998, the hedge fund Long Term Capital Management (LTCM) made a massive loss due to its leveraged holdings of Russian government bonds (GKO), which fell during Russia's financial crisis. Under the New York Fed's leadership, a consortium of 14 firms offered $3.625 billion to take over 90% of the LTCM's ownership to prevent it from failing, which would have spread losses to LTCM's short-term creditors. LTCM was allowed to resume its business under close supervision by the consortium members. Although there was no regulatory response after this crisis, the LTCM reminded us of the danger of high leverage and the fragility of complex risk management models based on historical correlations.[70]

In early 2008, the US government bailed out Bear Sterns to prevent its creditors from losses. The Fed offered $12.9 billion loans to facilitate a merger between Bear Stearns and JPMorgan Chase and $28.82 billion lending to purchase assets from Bear Stearns. In September 2008, the Treasury Department offered almost $200 billion to Fannie Mae and Freddie Mac to keep them solvent. The US government also took temporary control of AIG: the Treasury Department and the Fed offered a $141.8 billion fund in exchange for 92% of the AIG's ownership.[71]

Lehman Brothers' failure in September 2008, after the usual effort to find a buyer with government sweeteners failed, was the exception that proved the rule. After Lehman Bros. failed the Fed and Treasury used TARP authority to "inject" capital into large banks and to buy "toxic assets."[72]

Amid the financial crisis, due to limited access to car loans and decreased car sales, General Motors and Chrysler were in danger of bankruptcy. In December 2008, President Bush initiated a bailout of GM and Chrysler of $17.4 billion, using some funds from the Troubled Asset Relief Program. The Treasury Department also lent to and purchased the GM and Chrysler stocks. The bailout of the auto industry used about $81 million fund and was extended until 2014, imposing about a $10 billion cost to the taxpayers.[73]

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69 *Asian Financial Crisis*, FED. RSRV. HISTORY, https://www.federalreservehistory.org/essays/asian-financial-crisis (last visited Apr. 1, 2024).

70 *Near Failure of Long-Term Capital Management*, FED. RSRV. HISTORY, https://www.federalreservehistory.org/essays/ltcm-near-failure (last visited Apr. 1, 2024).

71 *See generally* W. Scott Frame, et al., *The Rescue of Fannie Mae and Freddie Mac*, 29 J. ECON. PERSPS. 25 (2015).

72 *Troubled Asset Relief Program*, *supra* note 20.

73 Andrew Glass, *Bush Bails Out U.S. Automakers, Dec. 19, 2008*, POLITICO (Dec. 19, 2018), https://www.politico.com/story/2018/12/19/bush-bails-out-us-automakers-dec-19-2008-1066932.

In response, the Dodd–Frank Act was passed in 2010, and Financial Stability Oversight Council was established to oversee the financial stability of "too big to fail" firms.[74] The Act also initiated the Consumer Financial Protection Bureau, in part to prevent overly risky mortgage lending.[75] In addition, the act introduced the Volcker Rule to restrict financial firms from risky trading and investment behavior.[76]

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[74] *See* 12 U.S.C. §§ 5301, 5481-5603; *Financial Stability Oversight Council*, U.S. DEP'T OF TREASURY, https://home.treasury.gov/policy-issues/financial-markets-financial-institutions-and-fiscal-service/fsoc (last visited Apr. 1, 2024).

[75] *Introduction to Financial Services: The Consumer Financial Protection Bureau (CFPB)*, CONG. RSCH. SERV. (Jan. 5, 2023), https://sgp.fas.org/crs/misc/IF10031.pdf.

[76] *Volker Rule*, BD. GOVS. OF THE FED. RSRV. SYS. (Jan. 30, 2020), https://www.federalreserve.gov/supervisionreg/volcker-rule.htm.

FINANCIAL REGULATION BEYOND STABILITY

Kathryn Judge[*]

In 2008, the failure of Lehman Brothers ignited a long-simmering financial crisis, bringing the economy to its knees. Under-capitalized banks were not the initial cause of the crisis, but they accentuated its magnitude and the depth of the recession that followed. The government's interventions to help Bear Stearns, AIG and other large financial institutions avert failure, while homeowners across the country found themselves underwater and often unable to access government support, accentuated the public outrage.

The economic devastation that followed, coupled with the pervasive sense of unfairness, led many to vow "never again." Financial stability became the mantra of the day, or really, the decade and a half that followed. Banks were subject to far more robust capital requirements, expanded liquidity requirements, and other enhanced prudential requirements. The Treasury Department was placed at the helm of a new Financial Stability Oversight Council to address systemic threats outside the banking sector. And scholars and policy makers undertook a broad and still robust debate, with many arguing the government should mandate far more significant structural changes to the banking and financial sector—all with the primary aim of promoting stability.[1] Throughout much of 2023 and 2024, a heated debate about the appropriate level and structure of capital requirements—one of the key mechanisms through which regulation promotes the safety and soundness of banks—has been playing out in congressional hearings, lengthy comment letters and even NFL advertisements.

The brightness of the spotlight on the debate about how to produce a more stable financial system, however, has largely overshadowed the many aims beyond stability that the government has long sought to promote via its regulation of finance and the financial system. Among the costliest obligations imposed on banks are those enlisting banks as front-line agents in the government's efforts to tackle money laundering. Banks and other financial institutions are obliged to institute extensive compliance regime and submit an array of reports to the government, often including detailed information about customers and their financial activities. The infrastructure used for anti-money laundering (AML) today is designed not only to prevent the laundering of ill-gotten gains, but also to prevent and detect corruption in the United States and abroad, to prevent and detect tax evasion, to prevent and

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1 See Part I, *infra.*

detect terrorist financing and, increasingly, to facilitate the implementation of sanctions serving purely foreign policy aims.[2]

There are some good reasons for the government to compel banks and other financial institutions to play a central role in this regime. Yet it has nothing to do with stability and cannot be justified by any market failure or identified externality. It is only by recognizing law enforcement and foreign policy as central government aims that the government can more easily pursue with the aid of financial institutions than without that one can begin to understand the regime now in place. This may help to explain why AML has garnered so much less attention than prudential regulation from lawmakers, academics, and the public.

The relative dearth of public and interdisciplinary engagement has not served AML or the myriad policy issues at play in the regime well. Even a brief glance at the AML regime currently in place suggests that despite the significant costs it imposes on banks and other financial institutions, the overall regime is far from effective, capturing only a small fraction of the illicit flows in the financial system. The regime also raises a host of difficulty policy questions, including tradeoffs among maximizing the efficacy of efforts to use of banks as instruments of statecraft, protecting privacy and other civil liberties and promoting broad access to financial services.

The relative neglect of AML despite its longstanding importance as a component of financial regulation is more the rule than the exception. It is emblematic of the ways that the focus on stability has often crowded out rigorous and broad debate about the myriad other policy aims at play in the regulation of finance. Saule Omarova and Graham Steele make a similar point in a new essay arguing that counteracting concentration and abuses of power are core principles that permeate bank regulation.[3] In a response to that essay, I show how the long history of unit banking in the United States helped to further the Brandeisian value of broad, diffuse economic opportunity.[4] Both pieces point to the important role that banking law has long played, and continues to play, in shaping both the structure of the banking system and, in turn, the structure of the real economy. Omarova and Steele argue that the excessive focus on stability predates the 2008 financial crisis, but the overall impact is the same: an excessive focus on stability has allowed other policy aims to whither from neglect.

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[2] For more information about the AML regime currently in place, how it has evolved, its efficacy and the fundamental tradeoffs at place, *see* Part II.A., *infra*; Kathryn Judge & Anil Kahsyap, *Anti-Money Laundering: Opportunities for Improvement, Wharton Initiative on Financial Policy & Regulation White Paper* (2024), https://wifpr.wharton.upenn.edu/wp-content/uploads/2024/03/WIFPR-Anti-Money-Laundering-Judge-and-Kashyap.pdf.

[3] Saule T. Omarova and Graham S. Steele, *Banking and Antitrust*, 133 YALE L.J. 1166, 1178 (2024).

[4] Kathryn Judge, *Brandeisian Banking*, 133 YALE L.J. FORUM 916 (2024).

Housing finance is another domain where the government has long played a very active role using the financial system to further policy aims that have little to do with stability.[5] Today, a majority of the home loans issued in the United States end up in a securitization vehicle backed by a government agency, Ginnie Mae, or a government-sponsored enterprise (GSE), Fannie Mae or Freddie Mac.[6] Yet Fannie Mae and Freddie Mac are operating in an indefinite limbo that no one ever wanted or designed. Back in 2008, the then newly created Federal Housing Finance Agency (FHFA) rapidly placed Fannie and Freddie into a government run conservatorship at the height of the financial crisis. Conditions long ago calmed, yet they have remained in this makeshift structure ever since. At the same time, the other government-sponsored enterprise originally designed to promote home ownership, the Federal Home Loan Banks, has become completely unmoored from its original function. They also have become massive and sometimes distortionary forces in the banking system, helping weak banks, such as Silicon Valley Bank (SVB) and Signature in 2023 and WaMu and Wachovia in 2008. Nonetheless, they have been allowed to carry on, handing out large paychecks to leadership and generous dividends to member banks while doing relatively little to actually support housing.

As with AML, housing finance is a domain of financial regulation where current policies and institutions position the government to play a central role shaping who has access to a mortgage, the terms of those mortgages, the types of financial institutions underwriting mortgages, who ends up holding or otherwise possessing economic rights in those mortgages. the nature of the markets in which they trade and much more. Housing finance, at this point, is a massive public-private ecosystem where the various public and private components have co-evolved, shaping each other iteratively and in various ways over time. And yet, as with AML, this is an area that gets a lot of attention from people who focus on housing and housing finance but is not currently the subject of the type of broad, robust debate among academics, policy makers, and industry in the ways leaders in those domains still come together regularly to discuss financial stability; nor is it a common topic in financial regulation despite being central to it.

This essay does not take any position with respect to the range of aims that financial regulation should promote, much less offer any suggestions about how to achieve any given aim. Its purpose instead is to suggest that issues such as AML, housing finance and the relationship between financial regulation and the structure of the broader economy are topics that merit far more attention than they currently receive in debates about financial regulation. Moreover, that neglect itself is costly. The recent work on the interplay

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[5] For a further discussion and support regarding housing policy as financial regulation, *see* Part II.B., *infra*.

[6] LAURIE GOODMAN ET AL., HOUS. FIN. POL'Y CTR., HOUSING FINANCE: AT A GLANCE MONTHLY CHARTBOOK, JUNE 2023 (2023), https://www.urban.org/research/publication/housing-finance-glance-monthly-chartbook-june-2023.

between banking law, antitrust and Brandeisian aims shows how the neglect of values and debates that were once central to banking has produced an industry structure and collateral consequences that may never have been allowed in the presence of more focused attention and yet which are difficult to change once entrenched. AML and housing finance are both exceptionally expensive in their current forms, and yet each, in different ways, is falling far short of achieving its core aims. Moreover, those aims are growing increasingly important. As geopolitical tensions continue to mount, the capacity to track financial flows globally could become increasingly important to U.S. foreign policy and other interests. Affordable housing, or lack thereof, is a pressing challenge that is not being met despite the massive funds and infrastructure available. This creates the possibility for meaningful upside from even modest improvements in how these ecosystems work. Nonetheless, all too often, bank regulators, academics, and even industry continue to focus an outsized amount of their energy on debates about capital regulation, liquidity regulation, resolution planning, deposit insurance, stress testing and the other components of a standard prudential regulatory diet.

All of those issues matter. I have dedicated much of my career to assessing threats to financial stability and I continue to focus much of my attention on how best to promote the resilience of the financial system. This essay is a self-critique as much as it is a critique of the field more broadly. As I started delving into the far messier world of anti-money laundering laws and learned to play around the edges of housing finance, part of me wanted to go back to focusing on stability—the aim is important, requires ongoing diligence, and also has a structure that facilitates rigor and debate. AML and housing finance, by contrast, are not domains where first-principles reasoning or efforts to start by identifying market failures and then making modest proposals to fix those failures will get you anywhere near understanding the morass already in place. But, this essay contends that making more effort to understand these domains, bringing rigor and structured debate to understanding how they do and should function, and promoting the type of multistakeholder conversation among academics, policy makers, and industry participants that has characterized debates about financial stability could go a long way toward improving actual policy outcomes.

This essay briefly reviews the ways stability has dominated regulatory and academic discourse about financial regulation. It then uses AML and the Federal Home Loan Banks (FHLBanks)—the oldest government foray into housing policy—as case studies to show that banks and the financial system are already deeply engaged in efforts to further other important government policies. These case studies affirm just how hard it can be to promote healthy public-private coordination, while also revealing why such arrangements have become so pervasive. More than anything, the aim here is to force acknowledgment of the myriad aims beyond stability that financial regulation already seeks to further, and to encourage more and broader engagement with these important areas of public policy.

I. STABILITY AS THE PARAMOUNT VALUE

Fifteen years after the failure of Lehman Brothers, the stability of the banking system remains the top priority of many. There are understandable reasons for this focus. The costly failures of SVB, Signature Bank, and First Republic Bank in the spring of 2023 and the decision by the Federal Reserve, Treasury Secretary, and the Federal Deposit Insurance Corporation to invoke extraordinary authority to protect all depositors in two of those banks was a reminder of the inherent fragility of banks and the adverse systemic effects such failures can trigger. Those failures, alongside the need for the United States to come into compliance with international standards, led to a host of new proposals to further safeguard banks and the banking system. If adopted, the Basel III endgame and other recent proposals will require the largest, most complex banks to meaningfully increase the amount of capital they use to fund their operations and will require regional banks to issue more long-term debt and calculate capital requirements in a manner more akin to that used by the largest banks.

The failures in the spring of 2023 also reinvigorated an academic debate about whether more should be done to bring stability to the banking system once and for all. This vein of the academic literature has deep roots.[7] It was reinvigorated with myriad new proposals for making banks safe following the 2008 financial crisis.[8] Scholars such as Adam Levitin and Laurence Kotlikoff issued blueprints for various forms of "narrow banking," requiring all deposits to be backed by safe assts.[9] Mervyn King, former head of the Bank of England, proposed ensuring stability by requiring banks to preposition at the central bank sufficient collateral to cover all deposits.[10] Morgan Ricks proposed eliminating "shadow banking," allowing only banks to issue liabilities of less than a year and having the government insure all of them as a way to stabilize the financial system.[11] Fast forward to today and each of these proposals is again under discussed. In 2023, Ricks, for example, joined forces with Lev Menand to put forth an ambitious plan to bring all money creation into the banking system and have banks function as utilities. Again, stability was a central, though purportedly no longer sole, aim.[12]

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7 For an overview of this history, *see* Jaromir Benes and Michael Kumhof, *The Chicago Plan Revisited*, 17–20 (Int'l Monetary Fund, Working Paper No. 12/202, 2012).

8 For a history and overview of safe banking proposals, *see* George Pennachi, *Narrow Banking*, 4 ANN. REV. FIN. ECON. 141, 148–49 (2012).

9 Adam J. Levitin, *Safe Banking: Finance and Democracy*, 83 U. CHI. L. REV. 357, 361 (2016); LAURENCE J. KOTLIKOFF, JIMMY STEWART IS DEAD: ENDING THE WORLD'S ONGOING FINANCIAL PLAGUE WITH LIMITED PURPOSE BANKING 172 (2010).

10 MERVYN KING, THE END OF ALCHEMY (2017).

11 MORGAN RICKS, THE MONEY PROBLEM: RETHINKING FINANCIAL REGULATION x–xi (2016).

12 *See* Lev Menand & Morgan Ricks, *Rebuilding Banking Law: Banks as Public Utilities*, YALE J. ON REG. (2023).

Stability and resilience have also been central in setting the agenda for debates about financial regulation that are far less ambitious in nature. Capital requirements, liquidity requirements, resolution planning and a host of other reforms and debates about financial regulation have largely been focused on just how much regulation, and in what suite of forms, is needed to achieve the necessary degree of stability, or at the least, resilience.

Throughout this line of literature is an assumption that stability is such a paramount goal that it could well justify imposing significant and often fundamental transformations in the nature of banking and should dominate financial regulatory debates even among those that are far less visionary. There are good reasons for this focus on stability, as the timing of these proposals reflect. I have spent much of my career trying to better understand the causes of financial dysfunction and the best ways to enhance the resilience of banks and the broader financial system. Whatever the path ahead, resilience should remain a priority. Yet the claim here is that the debate in financial regulation over the coming decades will and should shift from this core focus on stability to other useful, and perhaps even critical, functions that financial regulation already plays, sometimes quite poorly.

To be sure, that banks and other financial companies provide socially useful services has also been much discussed over the last fifteen years. Yet the implications of this possibility have tended to come in one of two forms. To oversimplify, many on the right seek to have banks do more by regulating them less. Trusting in markets and market participants, the idea is that by reducing regulatory burdens, banks can be trusted to engage in more socially valuable activities, such as making loans that increase the welfare of households and the productivity of businesses.[13] These debates thus often end up being framed, once again, about the optimal forms of regulation to promote resilience and stability.

On the left, the assumption has tended to be that in order for finance to do more to help households and the economy, banks should do less and the government should do more, often through the creation of new, large-scale, government administered programs. Mehrsa Baradaran, for example, has argued that in order to facilitate access to financial services, in ways that would benefit both marginalized households and the economy, post offices should be able to provide a host of banking services.[14] Morgan Ricks, Lev Menand, and John Crawford have argued that many of the challenges impeding access to certain financial services could and should be addressed by allowing

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[13] This debate played out at a recent hearing discussing the virtues and drawbacks of implementing a host of new capital requirements, commonly known as the Basel III endgame reforms. *See Implementing Basel III: What's the Fed's Endgame?: Hearing before the H. Subcomm. on Fin. Insts. and Monetary Pol'y*, 118th Cong. (2023), https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=408961.

[14] MEHRSA BARADARAN, HOW THE OTHER HALF BANKS: EXCLUSION, EXPLOITATION, AND THE THREAT TO DEMOCRACY 183 (2015).

people across the country to be able to have an account directly with the Federal Reserve.[15] Saule Omarova, sometimes in conjunction with Robert Hockett, has proposed an ambitious government program, the National Investment Authority, as the solution to ways that the financial sector may be falling short in how it allocates capital.[16]

By contrast to either of these extremes, as the next Part shows, many of the domains of financial regulation that get less attention involve public-private ecosystems—regimes that have gone far beyond partnerships in which the public and private components have co-evolved over time and remain mutually dependent on each other. These systems are not conducive to the type of first-best solutions currently being offered up by many academics, which may help to explain why they have been relatively overlooked. A core role of academics is to look beyond the current policy horizon and consider not just what is, but what could and should be. Efforts to think creatively and expansively about what the government can and should do or to argue vociferously against such interventions can play a valuable role helping to expand new policy horizons. Yet, as with the focus on stability, it is entirely possible to recognize the value of the work being done and acknowledge the high cost of the opportunities foregone when such creativity is not also being brought to bear on policies that are now in effect and are ripe for improvement.

II. PUBLIC-PRIVATE ECOSYSTEMS HIDING IN PLAIN SIGHT

A. *Anti-Money Laundering and Sanctions Infrastructure*

One of the most significant ways that banks are harnessed to serve governmental aims is through the role they asked to play as the eyes and ears of law enforcement and the enforcers of economic sanctions. The Bank Secrecy Act (BSA), as amended, puts banks in the position of playing a key role helping law enforcement investigate and prosecute a whole host of crimes, combatting corruption in the United States and abroad, trying to counter terrorist financing, and furthering an array of other policy objectives. The compliance infrastructure banks have in place to facilitate AML compliance has also been used with increasing import to impose economic sanctions, as were imposed against Russia following its invasion of Ukraine.

The fruits of this regime are significant and show just how much the government can gain from enlisting the help of banks. A 2018 survey by the Government Accountability Office of more than 5,000 employees across six federal agencies engaged in investigating and prosecuting crimes found that

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15 Morgan Ricks, J. Crawford, & L. Menand, *FedAccounts: Digital Dollars*, 89 GEO. WASH. L. REV. 113, 116–17 (2021).

16 SAULE OMAROVA, THE NATIONAL INVESTMENT AUTHORITY: AN INSTITUTIONAL BLUEPRINT (2022).

more than 72 percent reported using BSA reports to pursue investigations in the preceding three years.[17] Most of those had used that information for multiple aims, including quite often starting and expanding investigations.[18] The Criminal Investigation unit at the IRS reported in early 2023 that over the past three years, more than 83% of their investigations recommended for prosecution had a primary subject with a related BSA filing.[19] According to Jim Lee, head of the unit: "Hundreds of millions of dollars in restitution have been awarded to crime victims because our agents were able to use BSA data to prove a crime was committed." The 2022 National Money Laundering Risk Assessment put out by the Treasury Department is replete with case studies of how the BSA infrastructure was used to detect and prosecute a whole host of crimes.[20]

There are also some good reasons that public-private coordination of some sort may be necessary to achieve these types of aims. A regime that asks banks to keep records available and affirmatively turn over a tiny slice of transaction and customer data that they control is not that protective of financial privacy. Yet it is far more protective than if the government had direct access to all of the information available to financial institutions and other subject entities. At the other extreme, eliminating this regime entirely would not only make it far more difficult for law enforcement to do their jobs, but it would also undermine any deterrence effect this regime currently has with respect to each of the various aims it seeks to further.

Despite these significant fruits, and there being some reasons for a public-private regime of some sort in this domain, the current regime also seems to be performing well below what should be possible (admittedly, a hard thing to measure). Looking globally (itself part of the challenge, but the only way to assess actual efficacy here), available estimates suggest that this regime captures a mere 0.2 percent to 1.1 percent of illicit money flows.[21] Leaks of various forms further make it clear just how porous the current regime really is in practice. In 2020, for example, reporters got access to a small slice of the suspicious activity reports (SARS) and other confidential materials held by the Financial Crimes Enforcement Network (FinCEN), a body within

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17 U.S. GOV'T ACCOUNTABILITY OFF., GAO-20-574, ANTI-MONEY LAUNDERING: OPPORTUNITIES EXIST TO INCREASE LAW ENFORCEMENT USE OF BANK SECRECY ACT REPORTS, AND BANKS' COSTS TO COMPLY WITH THE ACT VARIED (2020).

18 *Id.*

19 IRS, PRESS RELEASE: BSA DATA SERVES KEY ROLE IN INVESTIGATING FINANCIAL CRIMES (Jan. 18, 2023), https://www.irs.gov/compliance/criminal-investigation/bsa-data-serves-key-role-in-investigating-financial-crimes.

20 DEPT. OF THE TREAS., NATIONAL MONEY LAUNDERING RISK ASSESSMENT (Feb. 2022), https://home.treasury.gov/system/files/136/2022-National-Money-Laundering-Risk-Assessment.pdf.

21 THOMAS PIETSCHMANN & JOHN WALKER, UNITED NATIONS OFFICE ON DRUGS AND CRIME, ESTIMATING ILLICIT FINANCIAL FLOWS RESULTING FROM DRUG TRAFFICKING AND OTHER TRANSNATIONAL ORGANIZED CRIMES 7 (2011); EUROPOL, CRIMINAL ASSETS BUREAU, DOES CRIME STILL PAY? CRIMINAL ASSET RECOVERY IN THE EU 4 (2016).

the Treasury Department that oversees and coordinates implementation of the BSA.[22]

The regime is also very expensive, with much of the expense borne by banks and other subject entities. An oft-cited annual survey by Lexis Nexis suggests that the total cost of financial crime compliance across financial institutions worldwide was $274 billion in 2022, with the great bulk of this cost incurred by institutions based in North America and Europe.[23] A 2018 survey by the Bank Policy Institute found that the largest banks in the survey spent a median expenditure of $600 million per year on AML compliance.[24] These costs don't just hurt banks; they can also make banks less likely to provide bank accounts and other services, harming people and small businesses.

In ongoing work with Anil Kashyap, I am exploring how to enhance the efficacy of this overall regime, and ways to better understand and address some of the inevitable tradeoffs that arise. That work examines uneven enforcement, frictions around information flows and other dynamics that can be addressed to improve outcomes without substantially increasing overall costs. It also illuminates the important civil liberties and economic liberties that, eventually, come into play and can help explain and justify a far from complete AML regime. Putting these considerations alongside one another should promote both a more effective regime and healthier engagement around the questions of when and how other important policy objectives should be traded off or protected in the design and implementation of the infrastructure around AML. Yet lurking behind this research is a looming question of just why AML seems to be performing so poorly despite the massive public and private resources invested in it.

As a starting point, it is clear that AML is an affirmative obligation imposed on banks in which they are being asked to provide a public service that flows from the nature of the services they provide, but not from any negative externality or market failure that might exist in the absence of regulation. Banks would likely avoid some money laundering on their own, given the reputational harm that can result. But less than savory clients can also be quite profitable. JP Morgan's relationship with Jeffrey Epstein, which yielded valuable connections for years while only later leading to reputational damage and potential liability is a high-profile example of the types of tradeoffs at play. It further illustrates the way the benefits are usually more near-term and more concrete than the costs. Given the imperfect incentives

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[22] *Global Banks Defy U.S. Crackdowns by Serving Oligarchs, Criminals and Terrorists*, INT'L CONSORTIUM OF INVESTIGATIVE JOURNALISTS (Sept. 20, 2020), https://www.icij.org/investigations/fincen-files/global-banks-defy-u-s-crackdowns-by-serving-oligarchs-criminals-and-terrorists/.

[23] LEXISNEXIS RISK SOLUTIONS, TRUE COST OF FINANCIAL CRIME COMPLIANCE STUDY (2022).

[24] BANK POL'Y INST., GETTING TO EFFECTIVENESS – REPORT ON U.S. FINANCIAL INSTITUTION RESOURCES DEVOTED TO BSA./AML & SANCTIONS COMPLIANCE 4 (2018), https://bpi.com/wpcontent/uploads/2018/10/BPI_AML_Sanctions_Study_vF.pdf.

that otherwise exist, fines and other regulatory action often become central drivers of private investments in developing robust AML regimes.[25]

In the abstract, appropriately calibrated penalties can theoretically help close the gap between private and public incentives, motivating banks to make the investments and other decisions that would otherwise be socially optimal. In practice, it doesn't seem to play out like that. For one thing, neither banks nor the government/public are monoliths here. Both are broad concepts that encompass a range of different actors with very different types of information, abilities, and incentives. Within banks, for example, AML compliance officers seem very aware that they are seen as cost centers, not revenue generators, and the overall aim of the organization is to maximize profits.[26] The risk of liability can induce investments in AML, but it is not just the level but also nature of those investments that ultimately matter for outcomes.

Similarly, although AML compliance officers often do view their work as meaningful and their interests aligned with the law enforcement officials that put their findings to work, interactions between AML officials and law enforcement are minimal. Instead, the primary spot of government interaction is through supervision and enforcement. And AML officials view these government actors with far more skepticism.

Each of these challenges illuminates a related impediment that helps explain why the imposition of fines may be a far from optimal tool for achieving optimal compliance: the lack of a clear baseline from which to measure deviations. Clearly, the goal of AML is not to require banks to invest infinite resources trying to ensure they identify and report all instances of possible money laundering or terrorist financing, so some mistakes must be tolerated. But AML does impose affirmative obligations on banks to implement compliance regimes, undertake customer due diligence, and file suspicious activity reports even when there is no clear evidence of wrongdoing. Ignorance is not an option.

The current framework tries to balance resource constraints and efficacy by requiring banks to institutionalize risk-based compliance systems.[27] In theory, this is an antidote to the common fear (and potentially still quite common practice) of check-the-box approaches to compliance. It asks banks to make informed judgments about the relative risks posed by different types of offerings and clients and to allocate resources and build internal infrastructure to reflect the relative risks.

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[25] For an overview of how large these fines can get, *see Top AML Fines in 2022*, COMPLY ADVANTAGE (July 26, 2023), https://complyadvantage.com/insights/aml-fines-2022/.

[26] *See, e.g.*, Colleen P. Eren, *Cops, Firefighters, and Scapegoats: Anti-Money Laundering (AML) Professionals in an Era of Regulatory Bulimia*, 2 J. WHITE COLLAR AND CORP. CRIME 47, 53 (disclaiming "'We are a cost center' and 'We are not a revenue-generating function.' These two sentences were repeated by a majority of the participants, suggesting that this is a firmly entrenched framing of the AML role.").

[27] *E.g.*, Introduction, FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL (FFIEC), BSA/AML MANUAL, https://bsaaml.ffiec.gov/manual (2015).

Yet even if this worked as well as theory suggests—and there are plenty of signs that it does not—there is still reasons to expect that the overall outcomes it produces would be far from socially optimal. At least six challenges remain.

First, the types of investments that can be induced through oversight and enforcement for failures could well be poorly matched to the types of investments that would enable the system to achieve meaningfully better outcomes. Technology, for example, is playing an increasingly important role in AML and its role is likely to increase. For an individual firm seeking to minimize expenditures while also taking steps needed to avoid or reduce fines, the types of technological investments that will be the most attractive are ones that: (1) reduce the type of violations that lead to fines or (2) reduces costs. Technological investments that could produce radically better outcomes, by contrast, are far less likely. This is both because there is no system of rewards, and because transformative developments often entail uncertainty and risk—not something that regulators have seemed overly willing to accept. Put bluntly, a compliance framework may get firms to want to minimize bad outcomes, but it does nothing to incent good outcomes. That would require a different type of framework.

Second, even if firms were willing to make investments focused on improving outcomes, the success of such efforts would depend critically on how those investments interacted with the broader ecosystem in which AML operates. Ultimately the burden lies with FinCEN and the myriad law enforcement agencies and other governmental bodies to make use of the information provided. Maximizing output is not just about maximizing the quality of the inputs but about the government's capacity to use the data provided to generate leads and other useful information. Public-private coordination around matters from standardizing data to the nature of the technology used to produce and analyze that data is key to overall success.

Third and relatedly, the coordination challenge here is huge. One reason is that privacy and other civil liberty concerns justify meaningful frictions in the transmission of information throughout this ecosystem. But the nature of the frictions goes far beyond and is poorly mapped onto legitimate efforts to protect privacy.

Fourth, economic liberties also come into play and can contribute to an even greater disconnect between the course of conduct that is privately and socially optimal. De-risking, that is refusing to provide certain types of financial services or to serve particular types of clients, is often the privately optimal response to a risk-based compliance regime but can also impede the ability of households and businesses to function as full participants in the economy. Even a government hesitant to impose universal or other affirmative service obligations on banks cannot turn a blind eye to the adverse impacts of its decisions to utilize the banking system to pursue other ends.

Fifth, as Kashyap and I explore, the aims of AML have a history of evolving. The optimal investments thus are often not ones that maximize

output for today's regime but the one that build an infrastructure capable of evolving over time.

Sixth and relatedly, for any transformation to be possible, regulators and supervisors must be willing to tolerate errors, even ones that are preventable with today's technology. Without a credible commitment to accept short-term shortcomings for long-term gains, banks are far less likely to be willing to invest finite resources in building out new types of capacity. Yet, such commitments are hard to come by, and practically speaking, can be very hard for supervisors and other regulators to make.

Taking a step back, this very brief look into AML suggests it is one of the most extensive public-private ecosystems, and one that is performing abysmally by some metrics. It also raises some interesting questions about the conditions that may be required for the regime to perform meaningfully better than it is. Typically, economics focuses on creating the right sets of incentives, and there could well be room for significant improvement in how fines are imposed and calibrated. Yet even this cursory analysis suggests that the system is unlikely to be optimized so long as it is conceived in oppositional terms. Similarly, an accountability mentality—while potentially useful in addressing some of the blatant weaknesses in AML regimes revealed by recent leaks—is unlikely to produce optimal outcomes. Meaningful cooperation may be needed.

There are a host of reasons that may be difficult to achieve right now, and many additional reasons to be worried about efforts at cooperation. Looking at the oldest component of the public-private ecosystem around housing finance brings some of these challenges into relief. For now, it suffices.

B. *Housing Finance: The Federal Home Loan Banks*

In 1931, President Herbert Hoover gathered builders, realtors, and others in the housing industry from around the country to the White House to explore what could be done to address the acute challenges afflicting the housing market and the structural challenges impeding the ability of middle-class Americans to buy their own homes.[28] A central focal point of the gathering was housing finance. At the time, the typical mortgages had quite short durations—often under five years, required large down payments (e.g., 50%), and were structured as balloon mortgages, in which regular payments

[28] ADAM J. LEVITIN & SUSAN M. WACHTER, THE GREAT AMERICAN HOUSING BUBBLE 44 (2022); President Herbert Hoover, *Statement Announcing the White House Conference on Home Building and Home Ownership* (Sept. 15, 1931), https://www.presidency.ucsb.edu/node/207591. For more on the history of the FHLBanks, *see, e.g.*, Kathryn Judge, *The Unraveling of the Federal Home Loan Bank System*, 41 YALE J. REG. __ (forthcoming 2024).

covered only interest and the full principal was due at the end.[29] President Hoover recognized that making it easier for people to access mortgages on favorable terms—with longer durations and amortization structures (with monthly payments covering principal and interest) that facilitated savings—could go a long way toward restarting the housing market and helping ordinary Americans build wealth and own their own home.[30] Yet government interventions of the type to come in housing—with widespread government guarantees of certain types of risk in order to facilitate a secondary market—were not something he was yet ready to embrace.

The solution was the Federal Home Loan Bank (FHLBanks) system, a government-sponsored enterprise that could raise money from the capital markets (still today aided by an expectation of a government backstop) and use the funds so raised to make collateralized loans to member institutions, thereby encouraging liquidity-strained members to make more of the types of loans that could be posted as collateral.[31] Although the FHLBanks today play a relatively modest role in housing finance, they continue to play a very significant role in the banking system. And they provide a useful case study in the virtues, dangers, and omnipresence of public-private coordination and cooperation in finance.

At the founding of the FHLBanks, the first pivotal policy decision was who should have access to this liquidity. The answer was shaped in part by the realities of the mortgage market, but also by what the government wanted the mortgage market to look like. Individuals that were a major source of mortgage finance at the time were excluded, as were commercial banks.[32] Those granted access were savings and loans and other types of thrifts—small, community-oriented financial institutions, typically structured as mutuals (meant to serve members, as opposed to profit-oriented, shareholder-owned organizations), designed to serve the needs of ordinary Americans and often, though not always, focused on residential housing—and insurance companies.[33] The first thrifts were modeled on counterparts abroad, and they proliferated rapidly, particularly as industrialization increasingly created groups of workers with stable incomes, other ties, and in need of homes. They played a critical role facilitating access to housing finance, but without any support, they proved incredibly vulnerable as housing prices went down and the economy contracted. Access to the FHLBanks made these inherently fragile institutions more resilient—a classic way government aids finance. But it also did something more.

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[29] LEVITIN & WACHTER, *supra* note 28, at 16–27.

[30] Natasha Porfirenko & James Ryan, *Archival Description of President's Conference on Home Building and Home Ownership*, ONLINE ARCHIVE OF CAL. (1998), https://oac.cdlib.org/findaid/ark:/13030/tf1w1001jf/entire_text/.

[31] *See* Federal Home Loan Bank Act, 12 U.S.C. § 1421 *et seq*.

[32] LEVITIN & WACHTER*, supra* note 28, at 48.

[33] *See* U.S.C. § 1424(a)).

The next issue was collateral. Here, the government sought to not only to use liquidity provisioning to increase the resilience of financial institutions that made home loans and the availability of (otherwise quite illiquid) home loans, but also to make modest changes in the types of loans available. It did this by defining qualified mortgages in ways that balanced credit risk with whether the loan actually met borrower needs, and imposing value caps on the home that secured the loan. The FHLBanks also allowed members to borrow more (via smaller haircuts) when posting loans that were particularly well suited to meet the needs of middle-class Americans, via longer durations and amortization structures designed to facilitate saving.[34]

The overall regime was a success in the first decades to come. It increased the availability of home loans, in part by enhancing the viability of thrifts that played a key role in the mortgage market. Small, community-oriented financial institutions have often played a key role providing local credit but are inherently vulnerable to shocks in the local or broader economy. By standing by, ready to provide fresh liquidity as needed, and helping to redistribute liquidity among thrifts, the Federal Home Loan Bank system illustrated just how impactful a government-sponsored enterprise could be.

The story of the FHLBanks in recent decades serves as a cautionary tale in the problems that can arise. A host of developments, including the introduction of a host of other more direct and expansive government programs that massively increased the availability and consumer-friendliness of housing finance, deregulation that swept away differences between thrifts and banks, and decisions by Congress to use the FHLBanks as a source of "off-balance sheet" revenue resulted in a much larger FHLBank System, and one far more focused on serving private aims. The biggest beneficiaries today are member banks, and the biggest users of the FHLBank system are the largest banks in the country (which were granted membership in 1989).[35]

Making matters worse, the FHLBanks have used their government-granted benefits to become a lender-of-second-to-last resort to all kinds of banks, undermining accountability with respect to the role of the Federal Reserve as the nation's designated liquidity provider of last resort and chronically enabling soon-to-fail financial institutions to limp along without correcting course. The failed Savings and Loans (S&Ls) of the 1980s were far more likely than healthy counterparts to borrow from the FHLBank system; the most significant banks that failed during the 2008 crisis consistently relied heavily on the FHLBank system to prop up their liquidity;[36] and, SVB

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34 *Id.* at § 1430(a)(1)).

35 Stefan Gissler & Borghan Narajabad, *The Increased Role of the Federal Home Loan Bank System in Funding Markets, Part 1: Background*, FEDS NOTES, BD. GOVERNORS THE FED. RSRV. SYS. (Oct. 18, 2017), https://doi.org/10.17016/2380-7172.2070.

36 Adam Ashcraft et al., *The Federal Home Loan Bank System: The Lender of Next-to-Last Resort?*, 42 J. MONEY, CREDIT AND BANKING 551 (2010).

and the other regional banks that failed in the spring of 2023 were major borrowers from their regional FHLBank.[37]

In short, the FHLBanks are a poster child of all that can go right and wrong in public-private ecosystems. Government-backed entities, even if only implicitly backstopped—are far better positioned than any private bank to raise funds during periods of distress, precisely when banks and borrowers most needed it. The FHLBank model takes this one step further, showing how the provision of liquidity and the extension of longer-term collateralized loans can enhance the resilience of small, community-oriented financial institutions and benefit the borrowers and communities that they serve.

Of course, the FHLBank system, as large as it is, remains a relatively modest component of the myriad ways the government has sought to promote housing finance and housing more generally. Today, the majority of all new mortgages issued end up in securitization vehicle backed by a government-sponsored entity, namely Fannie Mae or Freddie Mac.[38] Yet the current governance of Fannie and Freddie is not a regime anyone ever wanted. Back in September 2008, just prior to the failure of Lehman Brothers, the then-newly created Federal Housing Finance Agency (FHFA) placed Fannie and Freddie into conservatorship. In so doing, the government protected all of the creditors in Fannie and Freddie, just as the market had long suspected it would, while displacing the private shareholder governance that Congress had put in place for the two GSEs. The government then was forced to inject nearly $200 billion into the GSEs to keep them afloat. Yet more than fifteen years later, that stopgap measure remains in place. As former head of Freddie Mac opined in 2022: "It really is time, after more than 14 years, to stop kicking this can down the road."[39] Unfortunately, that is the path of least resistance, and thus the one that seems likely to persist absent more attention for academics and policymakers alike.

In short, the United States has a massive array of programs designed to promote home ownership. The federal government also incurs significant costs, including billions in foregone tax revenue, to support these programs.[40]

Nonetheless, the country is currently plagued by a multi-dimensional affordability crisis for which few see any simple or near-term solutions.[41] A

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37 Fed. Home Loan Bank of S.F., Annual Report (Form 10-K) (Mar. 10, 2023).

38 Urban Institute, *Housing Finance at a Glance: A Monthly Chartbook* (Dec. 2023), at https://www.urban.org/tags/housing-finance-glance-monthly-chartbook-december-2023; Donald H. Layton, *The Fannie Mae and Freddie Mac Endgame*, THE HILL (Oct. 18, 2022), https://thehill.com/opinion/finance/3694135-the-fannie-mae-and-freddie-mac-endgame/.

39 *Id.*

40 Emma Waters, Owen Minott & Andrew Lautz*, Is it Time for Congress to Reconsider the Mortgage Interest Deduction?*, BIPARTISAN POL'Y CTR. EXPLAINER, (Nov. 2, 2023), https://bipartisanpolicy.org/explainer/is-it-time-for-congress-to-reconsider-the-mortgage-interest-deduction/.

41 *The Affordable Housing Crisis Grows While Efforts to Increase Supply Fall Short,* GAO BLOG (Oct. 12, 2023) https://www.gao.gov/blog/affordable-housing-crisis-grows-while-efforts-increase-

recent study found that half of those living in New York City cannot afford to live there given housing costs, and other cities face similar challenges.[42] Rather than helping to address the supply constraints and other challenges contributing to that crisis, many of the programs currently in place function primarily to facilitate wealth transfers, often benefitting the wealthy and financial institutions, while doing little to promote access to affordable housing.

Taking a step back, the early days of the FHLBank system demonstrated how private-public ecosystems can accomplish aims that neither could achieve without mutual support. Although in a way that is very different than AML, the original FHLBank system shows how public-private coordination can create outcomes not achievable by public or private mechanisms alone. The FHLBank system also embodies the reasons that so many academics, and others have become disillusioned with such arrangements as well. The tendency for even well-designed regimes to decline over time is hard to ignore.

Nonetheless, this is a system that current exists and is massive, with debt outstanding well in excess of $1 trillion.[43] The FHFA has recently issued a very useful report trying to lay out possible reforms.[44] Yet the proposed reforms would be more incremental than transformational, and the FHLBanks are working aggressively to fight even those reforms.[45] More importantly, the report, which had been more than a year in the making, garnered only modest attention and triggered none of the type of public engagement and debate that would be needed for meaningful reform. Echoing Don Layton, it is past time to stop kicking the can down the road, allowing a regime that is obviously suboptimal by any objective standard to continue to bilk an implicit public backstop primarily for the benefit of member financial institutions and highly paid executives.[46]

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supply-fall-short; Neil Irwin, *Why America's Housing Crisis Has Hit A New Inflection Point*, AXIOS (Sept. 19, 2023), https://www.axios.com/2023/09/19/housing-affordability-crisis.

42 Eliza Shapiro, *Half of N.Y.C. Households Can't Afford to Live Here, Report Finds*, N.Y. TIMES (Apr. 25, 2023), https://www.nytimes.com/2023/04/25/nyregion/affordable-housing-nyc.html; Joe Seydl, *When Will the Crisis in U.S. Housing Affordability End — and How?* (Nov. 14, 2023), https://privatebank.jpmorgan.com/nam/en/insights/markets-and-investing/ideas-and-insights/when-will-the-crisis-in-US-housing-affordability-end-and-how.

43 Noah Buhayar, Heather Perlberg, & Austin Weinstein, *A $1.3 Trillion Home-Loan System Gone Astray Is Fighting an Overhaul,* BLOOMBERG NEWS (Dec. 20, 2023), https://www.bloomberg.com/news/articles/2023-12-20/federal-home-loan-banks-why-lobbyists-are-fighting-housing-lending-reform?sref=0SF97H1m.

44 FHFA, FHLBank System at 100: Focusing on the Future (2023), https://www.fhfa.gov/PolicyProgramsResearch/Programs/Pages/FHLBank-Focusing-on-the-Future.aspx.

45 Buhayar, Perlberg, & Weinstein, *supra* note 43.

46 Judge, *supra* note 28.

CONCLUSION

For the first decade after the financial crisis of 2008, there were good reasons for the robustness of the debate about financial stability to largely dwarf other conversations on financial regulation. The bank failures of spring 2023 were a reminder that stability can never be taken for granted. But the excessive focus on stability has elided the reality that financial regulation already serves many other aims, from helping law enforcement go after drug traffickers to making it easier for families to own their own homes to promoting a more diffuse allocation of power and opportunity. These domains and aims are messy, having developed over decades, and in ways that are not conducive to first-best reasoning, whether economic or otherwise. Yet this is more reason, not less, for academics, think tanks and other institutions suited to promote robust and informed debate should be leading these conversations rather than avoiding them.

Rigorous analysis and public debate have the capacity to bring rigor and fresh thinking to important policy problems. By looking beyond the horizon of what is politically feasible in the short term—often the focus when conversations are dominated by those entrenched in a regime as it now exists—a broader set of voices can help lay the foundations for new and better approaches to policy making. Hopefully in the years ahead, more academics and other intellectuals will display even more willingness to move beyond the methodologies embraced in ivory towers and engage further with the challenges and great opportunities now at play in financial regulation in the broad terms in which it is actually put into practice.

A PROPOSAL FOR REMOVING GOVERNMENT AGENCIES FROM SUPERVISING OR INSURING BANKS AND S&LS

Peter J. Wallison[1]

I. THE GOVERNMENT—PRIMARILY THE FED—AS BANK SUPERVISOR

In March 2023, three large U.S. banks failed, and one was closed and liquidated.[2] The most prominent failure was Silicon Valley Bank, a California chartered bank for which the Federal Reserve was the federal safety and soundness supervisor. Two of the banks were among the 30 largest U.S. banking organizations and had been considered "well-capitalized" up until the time of their failure.[3] The failures triggered runs on other banks around the United States, which the government was able to forestall by promising to protect all deposits beyond the $250,000 deposits already protected by the FDIC.[4] As bad as this was, it was only the latest in a continuum of bank failures and financial crises that have characterized the U.S. financial system for the last 100 years.

Indeed, this was nothing new, but simply a shadow of earlier years. In a 2013 speech to the Chicago Fed, Bill Isaac, a former chair of the Federal Deposit Insurance Corporation from 1978 to 1992, noted:

> The period from 1978 to 1992 was exceptionally tumultuous for the U.S. economy and financial system. . . . Our largest banks were loaded with loans to lesser developed

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[1] The general proposal in this paper for a privatized system of bank and S&L supervision was first advanced in a book entitled *Back from the Brink: A Practical Plan for Privatizing Deposit Insurance and Strengthening Our Banks and Thrifts,* published by the American Enterprise Institute in 1990. PETER J. WALLISON, BACK FROM THE BRINK (1990). That proposal, in the wake of the S&L crisis of 1985-1989, was written by Peter J. Wallison, with detailed footnotes by Bert Ely. This paper leaves out a great deal of the original work's details but adds a discussion after recent bank crises about the failures of the Fed as a bank supervisor and conflicts of interest between the Fed's monetary policy role and its role as a bank supervisor.

[2] *See FDIC: 2023 Bank Failures in Brief*, FED. DEPOSIT INS. CORP., https://www.fdic.gov/resources/resolutions/bank-failures/in-brief/bfb2023.html (last visited Mar. 25, 2024).

[3] U.S. GOV'T ACCOUNTABILITY OFF., GAO 23-106974, *Bank Supervision: More Timely Escalation of Supervisory Action Needed* 10-11 (2024), https://www.gao.gov/assets/d24106974.pdf; Gov't Accountability Off., *GAO Highlights: Bank Regulation* (Apr. 2023), https://www.gao.gov/assets/gao-23-106736-highlights.pdf (last visited Mar. 25, 2024); Silicon Valley Bank, Message to Stakeholders Regarding Recent Strategic Actions Taken by SVB at 2 (Mar. 8, 2023), https://s201.q4cdn.com/589201576/files/doc_downloads/2023/03/r/Q1-2023-Investor-Letter.FINAL-030823.pdf.

[4] Press Release, Fed. Rsrv., Joint Statement by Treasury, Federal Reserve, and FDIC (Mar. 12, 2023), https://www.federalreserve.gov/newsevents/pressreleases/monetary20230312b.htm.

> countries. The Federal Reserve, FDIC, and Treasury developed a contingency plan to nationalize the major U.S. banks if the LDC countries renounced their debts. Some 3,000 insured banks and thrifts failed during this period. Our seventh largest bank, Continental Illinois, in downtown Chicago, failed and was in effect nationalized by the FDIC and many regional banks went under, including nine of the ten largest banks in Texas.[5]

More recently, the FDIC reported that there were 516 bank failures between 2009 and 2023.[6] Since the 1970s, over 90 banks with assets of $1 billion or more have failed.[7]

The safety and soundness of U.S. banks are the responsibility of three government agencies, the Federal Reserve (Fed), the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC). The Fed is by far the largest of these—with the broadest responsibility—regulating and supervising over 4,900 bank holding companies, 839 state member banks, 470 savings and loan holding companies, 154 foreign banks operating in the U.S., 41 Edge Act and agreement corporations, 52 state member banks foreign branches, 40 financial holding companies, 442 domestic financial holding companies, and 8 designated financial market utilities.[8] The OCC regulates and supervises a little over 1000 national banks,[9] and the FDIC is the safety and soundness regulator for over 5000 national and state chartered banks and savings associations.[10]

There have been three major financial crises involving regulated and supervised banks and S&Ls just since the 1980s—one centered in 1989 involving bank and S&L failures with aggregate losses of $390 billion, one in 2008 with aggregate bank losses of $515 billion, and the one in 2023 with losses of $319 billion.

This is an unenviable—maybe even scandalous—record.[11] Not only has the FDIC been required to compensate the depositors in all these banks who had insured deposits, but it reduced the profitability of all surviving banks that had to pay higher rates for deposit insurance afterward. The losses to uninsured depositors, and to other individuals, businesses, and the economy generally have not apparently been calculated or reported, but were substantial. Once again, for its regulatory failures, the Fed apologized to Congress

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[5] William Isaacs, Speech to the Chicago Fed (2013) (on file with author).

[6] *FDIC: Bank Failures in Brief – Summary*, FED. DEPOSIT INS. CORP., https://www.fdic.gov/resources/resolutions/bank-failures/in-brief/index.html (last visited Mar. 25, 2024).

[7] Shane Barber, *What's Going on with Bank Failures*, MOD. WEALTH MGMT. (Mar. 16, 2023), https://www.modwm.com/whats-going-on-with-bank-failures/.

[8] *The Federal Reserve System Purposes and Functions: Function*, FED. RSRV., https://www.federalreserve.gov/aboutthefed/files/pf_5.pdf (last visited Mar. 25, 2024).

[9] *About OCC*, OFF. OF THE COMPTROLLER OF THE CURRENCY, https://www.occ.treas.gov/about/index-about.html (last visited Mar. 25, 2024).

[10] *What We Do*, FED. DEPOSIT INS. CORP., https://www.fdic.gov/about/what-we-do/ (last visited Mar. 25, 2024).

[11] There have been efforts in Congress to remove the Fed's safety and soundness authority over the banking system. According to a March 16, 2023, note by Aaron Klein of the Brookings Institution, Sen. Dodd's first draft of what became the Dodd-Frank Act removed the regulation and supervision of banks like SVB from the Fed.

and said it is reviewing its activities and systems with a view to improving them. But it is always thus, with another financial crisis certain to come in the years ahead.

It is the thesis of this paper that government regulation and supervision of U.S. banks—by the Fed, the OCC, and the FDIC—is both ineffective and an increasing danger to the U.S. economy. It is a failure of all the agencies involved, but particularly the Fed, which has the largest and most important portfolio of banks and bank holding companies to regulate and supervise. Among other things, it has become clear that the Fed has a conflict of interest between its monetary policy activities and its bank supervision. For this reason alone, the United States needs an entirely new system for both bank supervision and deposit insurance.

Accordingly, to create a more stable, safe, and sound U.S. banking system, the regulation and supervision of the U.S. banking industry should be transferred to a new and independent private regulatory structure—based on and utilizing the financial resources and knowledge of the banking industry itself—that can focus on the safety and soundness of the financial institutions it is supervising. Such a system, as described in Section II below, will not require any government involvement or resources and, through risk-based deposit insurance, will be able to produce a more stable banking industry than the U.S. has experienced since the founding of the Federal Reserve in 1913.

After the most recent collapse, the Government Accountability Office (GAO) found that risky business strategies, along with weak risk management, contributed to the failures of Silicon Valley Bank and Signature Bank. In both banks, rapid growth was an indicator of risk, but the Fed did nothing effective to prevent their eventual collapse. In 2019-2021, the total assets of Silicon Valley Bank and Signature Bank grew by 198 percent and 134 percent respectively—far exceeding growth for a group of 19 peer banks (33 percent growth in median total assets).[12] To support their rapid growth, the two banks relied on uninsured deposits, which can be an unstable source of funding because uninsured depositors are more likely to withdraw their funds during times of stress.[13] Moreover, it is now possible for depositors to withdraw funds electronically, without having to appear at the bank's teller windows. This makes bank "runs" even more uncontrollable.

In the 5 years prior to 2023, regulators identified concerns with Silicon Valley Bank and Signature Bank, but both were slow to mitigate the problems the regulators identified, and regulators did not escalate supervisory actions in time to prevent failures.[14]

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[12] U.S. GOV'T ACCOUNTABILITY OFF., GAO 23-106736, PRELIMINARY REVIEW OF. AGENCY ACTIONS RELATED TO MARCH 2023 BANK FAILURES 11 (2023), https://www.gao.gov/assets/gao-23-106736.pdf [hereinafter U.S. GAO 23-106736].

[13] *Id.* at 12–13.

[14] *Id.* at 17–23.

An example of the dysfunction that currently prevails—and has for many years—is clear in the GAO's report to the relevant House of Representatives committee about how the Fed addressed some deficiencies in SVB's risk-management program. According to this report, "on June 30, 2022, FRBSF downgraded SVB's [ratings]. . . . [E]xaminers found that the bank's management and board performance needed improvement and were less than satisfactory."[15] Among many other things, the San Francisco Federal Reserve Bank (FRBSF), the regulator and supervisor of SVB, believed that the bank's risk management system "did not address foundational, enterprise-level risk-management matters."[16] Accordingly, the Fed's supervisory staff "stated its intent to initiate an informal, nonpublic enforcement action, in the form of a memorandum of understanding with SVB Financial Group and SVB."[17]

FRBSF staff told GAO that the San Francisco Fed staff started working on the memorandum of understanding (MOU) in late August 2022, with collaboration from the Federal Reserve staff, the Federal Reserve's legal staff and the Federal Reserve's Board staff, and that—even after all that staff involvement—the memorandum ultimately needed "senior-level review."[18] Then, after all this consultation the, "memorandum of understanding was subsequently kept open to allow for the completion of additional examination work" by FRBSF.[19] "However," the account ends drily, "the Federal Reserve did not finalize [the memorandum] before SVB failed in March 2023."[20] That's eight months of delay, allowing another needless bank crisis and the loss of several billion dollars for the government, bank shareholders and depositors, and the U.S. economy.

This is undoubtedly not the only case where the Fed's supervisory staff failed to prevent a bank collapse. As noted above, there have been three major financial collapses involving insured and supervised banks—many of them Fed supervised banks—since 1980. It is no surprise that a government bureaucracy could not get its act together effectively, but the question is whether the same government bureaucracy that has always acted slowly on every other matter can be expected to perform differently when billions of dollars and the stability of the U.S. economy is at stake. The many financial crises in the U.S. make clear that the answer is no.

The FDIC was the primary safety and soundness regulator of Signature Bank, and its actions were no better than the Fed's. The GAO reported that "FDIC had not completed its 2022 examination documents for Signature Bank at the time of its failure. . . . According to preliminary findings we

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[15] *Id.* at 21.
[16] *Id.*
[17] U.S. GAO 23-106736, *supra* note 12, at 22.
[18] *Id.*
[19] *Id.*
[20] *Id.*

reviewed from FDIC's 2022 liquidity target examination, FDIC planned to reiterate its 2019 matter requiring board attention on liquidity contingency planning."[21] It also had drafted a new "matter requiring board attention" on liquidity contingency planning.[22] "FDIC stated that because Signature Bank did not mitigate its liquidity and management-related issues in a timely manner, FDIC issued an interim CAMELS rating downgrade on March 11, 2023, the day before Signature Bank was closed[.]"[23]

Clearly, both the Fed and the FDIC were dilatory in their responses to both SVB and Signature Bank. That in itself, after all the problems in the US banking system over the last 100 years, must be remedied. The fundamental question is whether government agencies have the ability to respond promptly even when problems are identified. In most cases where government operates, bureaucratic foot-dragging can be tolerated, but it's clear that this is not permissible in bank regulation.

But it is not only the Fed's and FDIC's bureaucratic sluggishness that is a problem. There are also elements of the Fed's role as monetary authority that interfere with effective bank regulation.

During the relevant period, the Fed's FOMC first raised interest rates, lowered them to historic lows, then raised them again.[24] These steps were taken to deal with the Fed's responsibilities for price stability and economic growth. It may be that these dual responsibilities—assigned by Congress—are inconsistent with one another. It may not be possible for the Fed to do both. Economic growth and jobs may require the Fed to lower interest rates, while price stability seems to require the Fed to raise interest rates to combat inflation. Performing both of these roles effectively may be impossible, and Congress should consider whether it would make sense to focus the Fed only on its initial responsibility—to assure price stability and the value of the dollar.

Nevertheless, we are where we are, and in considering the Fed's responsibility for bank safety and soundness we have to recognize how that responsibility is affected by the Fed's role in the economy. In this respect, there seems to be a clear conflict of interest. While the Fed wants to improve economic growth and employment, the Fed's bank supervisory system should be preventing banks from taking substantial credit risks. On the other hand, when the Fed wants to fight inflation and raises interest rates, that weakens the banks, as it clearly weakened SVB by reducing the value of their loan and securities assets.

As an example, beginning in 2008, when the economy was in the midst of the 2008 financial crisis, many large companies were in trouble—or had

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21 *Id.* at 25.

22 U.S. GAO 23-106736, *supra* note 12, at 25.

23 *Id.*

24 *Open Market Operations*, FED. RSRV., https://www.federalreserve.gov/monetarypolicy/openmarket.htm (last visited Mar. 25, 2024).

already failed—and the U.S. unemployment rate had reached 10 percent.[25] This was obviously the time for a Fed interest rate cut, and it did this by increasing the money supply and reducing bank reserve requirements between 2008 and 2014.[26] These actions would put downward pressure on interest rates to support economic activity and job creation.

Then, beginning in 2015, when market interest rates had reached an historic low of 0.25-0.50 basis points, the Fed began to raise rates again, probably to forestall what it saw as inflationary pressures.[27] Twenty-five basis point increases began again in late 2016 and continued through the end of 2018, when the rate had reached 2.25-2.50 percent.[28] Then, unsatisfied with the growth in the economy and no longer worried about inflation, the Fed began to cut rates every few months until by October 2019 the rates were 1.50-1.75 percent.[29]

When the Fed cut interest rates, its purpose was to encourage banks to take more risks—making more low interest loans to stimulate economic growth. When interest rates are low, banks are competing for good loans, but when interest rates reach something less than one percent, banks are competing for any loans available in the market. Then, when interest rates rise again, the loans that banks have put on their books—even Treasury securities—lose value because their rates are well below the new market rates.

Thus, in 2020, when the Fed was concerned about the rate of economic growth, it cut rates 50 basis points in early March and another 100 points in mid-March.[30] Rates again remained historically low for a year until the Fed began a series of increases in March 2022 (25 bps), May 2022 (50 bps), and 75 bps in June, July, September, and November, and 50 bps in December.[31] As is well known, SVB had a substantial amount of mortgage-backed securities and high quality Treasury bonds on its balance sheet, but as interest rates rose these began to lose value.

So, by 2023, the Fed had increased rates rapidly in 2022, after cutting rates in the year before that. Now, it began a series of increases of 25 bps in February. March, May and July of 2023.[32]

The purpose of a rate cut is often to encourage banks to lend more and take more risk. This is especially true when the Fed is trying to keep the economy from falling into recession, or worse. Low interest rates encourage individuals and businesses to borrow. In these cases, which may have the character of emergencies, the Fed may (and has) cut interest rates to zero or near zero. Under these circumstances, banks almost always take substantial

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[25] Peter S. Goodman, *U.S. Unemployment Rate Hits 10.2%, Highest in 26 Years*, N.Y. TIMES (Nov. 6, 2009), https://www.nytimes.com/2009/11/07/business/economy/07jobs.html

[26] FED. RSRV., *supra* note 24.

[27] *Id.*

[28] *Id.*

[29] *Id.*

[30] *Id.*

[31] *Id.*

[32] FED. RSRV., *supra* note 24.

risks in trying to find assets that pay any kind of interest, and these assets can be, and often are, riskier than the loans the same banks might make when the economy is functioning well.

What were bank supervisors expected to do when rates are rapidly rising and falling because of Fed policies? In these cases, regulators and supervisors would have to be particularly careful about the quality of the assets banks are acquiring. However, it would not be surprising to find that in cases of low or zero interest rates, Fed regulators are not conditioned to worry about the assets banks are acquiring. To wade in with restrictions about loan quality during this period would be inconsistent with the FOMC's policy of stimulating economic growth. But on the other hand—from the perspective of safety and soundness—regulators and supervisors have a special responsibility to make sure that banks don't weaken themselves for the future, when interest rates return to normal levels, or higher, depending on the Fed policy.

These increases and decreases in interest rates reflect Fed policy, adopted by the Fed's Open Market Committee, often after considerable debate and controversy. The Vice Chair for Regulation and Supervision is a member of this powerful committee and has a vote in the group's decisions. He or she, accordingly, probably feels an obligation to see that regulatory or supervisory policies are consistent with the outlook for the economy assumed by the FOMC when it changes its view from raising to cutting interest rates. Thus, when interest rates are low the Fed's safety and soundness regulators are not likely to penalize banks for making risky loans, and when interest rates rise Fed safety and soundness regulators are in a weak position to penalize banks for having the risky loans on their balance sheets that the FOMC wanted them to take on.

Needless to say, this is the essence of a conflict of interest, and is an untenable position for a bank safety and soundness regulator. The ideal case would be that the safety and soundness regulator should follow a consistent policy over the years—limiting the number of low interest loans or otherwise risky loans when the Fed is trying to encourage these loans, because these loans will turn out to be problematic when interest rates rise again. Or, correspondingly, when interest rates are rising or high as a result of the Fed's effort to combat inflation, the safety and soundness regulator should have previously followed policies that would limit the effect of higher interest rates on bank assets of loans and securities. The result should be a consistent policy over time.

It can be argued that the U.S. has had so many financial crises because the Fed, in its role as safety and soundness bank supervisor, had simply accommodated the interest rate policies of the Chairman and the Federal Open Market Committee instead of a policy that would accommodate the inevitable future changes in interest rates.

In other countries, there is no direct link between the monetary authority's interest rate policies and the regulatory policies of the bank supervisor. In Canada, for example, the monetary policies of the country are managed by

the Bank of Canada,[33] which has all the general authorities of the Fed to raise and lower interest rates, but the oversight of banking organizations in Canada is done by the Office of the Superintendent of Financial Institutions (OFSI), which is an agency of the Department of Finance, managed by the Minister of Finance.[34] Deposits in Canadian banks are insured by yet another independent agency.[35] It may not be coincidental that Canada has not had a single bank failure in the past 30 years.[36]

II. A NEW PRIVATE SECTOR SYSTEM FOR THE REGULATION AND SUPERVISION OF U.S. BANKS AND S&LS

The book *Back from the Brink*, from which this paper is partially adapted, focused on the then most recent financial disaster, the collapse of the Savings and Loan (S&L) industry, and the fact that the disaster was brought about by the deposit insurance system—a system designed to assure S&L depositors that they could safely deposit their savings in S&Ls. The paper noted:

> In every other area of the economy, where the distorting effect of federal deposit insurance is not present, the market denies funds to undercapitalized entities or to those whose prospects for using new money profitably are perceived to be dim. . . . [However], the introduction of discipline in the form of deposit risk, while it may discipline managers, also introduces an instability that may do more damage to the economy than the deficiency it is meant to cure. For that reason, the crude interventions of depositor discipline have historically been rejected in favor of comprehensive deposit insurance, with discipline supplied by government regulation and supervision. The S&L debacle, if it shows nothing else, demonstrates that government regulation and supervision are not wholly adequate to this task.[37]

These words were written more than 30 years ago, and ring even truer today. Again and again over these 30 plus years, we have seen that government regulation cannot substitute effectively for market discipline. Indeed, in some of the financial crises we have experienced—such as the financial crisis of 2008—government housing policies were the proximate cause of the financial crisis by leading the private sector. There, without any interference by bank regulators, banks were led into a swamp of low-quality mortgages.

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33 *About us*, BANK OF CANADA, https://www.bankofcanada.ca/about/ (last visited Mar. 25, 2024).

34 *The OFSI story*, OFF. OF THE SUPERINTENDENT OF FIN. INST., (Mar. 25, 2024), https://www.osfi-bsif.gc.ca/en/about-osfi/osfi-story.

35 *About CDIC*, CANADA DEP. INS. CORP., https://www.cdic.ca/about-us/ (last visited Mar. 25, 2024).

36 Courtney Reilley-Larke & Aaron Broverman, *The Silicon Valley Bank Failure: Why Banks Don't Fail In Canada Like in the U.S.*, FORBES (Feb. 12, 2024), https://www.forbes.com/advisor/ca/banking/silicon-valley-bank-failure.

37 WALLISON, *supra* note 1, at 2.

Then, in the wake of the resulting crisis, government policymakers handed yet more power to the Federal Reserve.

Of course, the government's solution was to tighten some of the rules and promise to do better. Everything wrong, of course, was fixed. But here we are in 2024, a year after a crisis produced by the Federal Reserve and (again) the FDIC. So again, I am suggesting that we look at the possibility of a private deposit insurance system run by the banking industry itself.

This will raise a number of questions in the minds of people who—despite all—still trust the government to make things right. But if 100 years of successive failure are not enough to warrant a substantial change in a government program, the U.S. deserves the wasteful financial crises it will endure in the future.

The important thing to recognize is that using the banking system to protect the safety and soundness of banks was how things worked before the Federal Reserve was established. At that time, there were bank clearinghouses in most of the major U.S. cities. In fact, these are the cities where many of the Federal Reserve Banks are now located. The clearinghouses were where debts and credits among the local banks were settled. As the system strengthened over time, clearinghouses took on other stabilizing activities. If a bank in the system failed, the clearinghouse would issue its own notes, known as clearinghouse certificates. These were backed by the capital of all the banks in the clearinghouse, and thus were trusted by the public. The clearinghouse notes circulated like cash, and when there was no further question about the health of the other banks in the system, the clearinghouse notes were withdrawn.

The clearinghouse system was highly efficient, in part because the conditions of most banks were monitored by the clearinghouses to which they belonged, and by other banks. Banks that were not well managed, or taking too many risks in the view of their contemporaries, could be excluded from the clearinghouse. Exclusion was obviously a very bad sign to the public at large.

Nevertheless, the system was not yet mature. In 1907, there was a panic with runs on a number of banks at the time of a stock market collapse.[38] The reasons for the panic have never been entirely clear, but it was stopped when J.P. Morgan began to shore up banks with his personal funds.[39] The lessons drawn were that the US Treasury was not able to keep banks afloat when large numbers of depositors wanted to withdraw their funds. This eventually gave rise to the Federal Reserve and its regulation and supervision of state-chartered banks and bank holding companies.

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[38] Jon R. Moen & Ellis W. Tallman, *The Panic of 1907*, FED. RSRV. HIST. (Dec. 4, 2015), https://www.federalreservehistory.org/essays/panic-of-1907.

[39] Richard A. Naclerio, *The Panic of 1907: How J.P. Morgan Took Over Wall Street*, GOTHAM CTR. (Apr. 20, 2021), https://www.gothamcenter.org/blog/the-panic-of-1907-how-jp-morgan-took-over-wall-street.

Here, then, we have two elements that, if properly employed, could be the basis of a private safety and soundness supervision system: (i) the capital of all the banks in a given system—not a fund requiring replenishment like the FDIC—is what stands behind the creditworthiness of each bank (that number, incidentally, was $2.260 trillion in the first quarter of 2023), and (ii) the responsibility for ensuring that each bank in the system is well-managed and operating safely rests with the other banks—that is, banks with a knowledge of the market and the pressures under which all banks are operating are the ones that will bear the risk of whether other banks are operating safely.

A. *The Monitoring System.*

It would not be feasible, of course, for each bank to monitor all other banks. That might have been true in the clearinghouse period, but not today. However, in the banking world today it should not be difficult to create a whole industry of private firms made up of or employing qualified bank monitoring specialists, together with syndicates of banks willing—for a fee—to insure the depositors of banks and S&Ls against loss of all of their deposits.

In this system, a monitoring group ("MG"), a private company somewhat like an accounting firm that employs qualified bank monitors and supervisors, would contract with the banks it will monitor. Indeed, accounting firms could find this activity to be a natural extension of their business. An MG could monitor dozens of banks. The Fed doesn't charge for its regulatory and supervisory activity, but as we have seen it doesn't do a particularly effective job either. The MG would be compensated by fees negotiated with the banks that it monitors.

Given that this structure involves thousands of banks and S&Ls, and perhaps hundreds of MGs, it should be possible to establish monitoring rates annually through a bidding process. In effect, this will form the basis of a risk-based bank monitoring fee, a system that the current government system has never been able to establish. Over time, as a bank's condition remains healthy through both easy and troubled periods, the bids for monitoring it will decline. In this way, well-managed banks and those with high or excess capital will be able to benefit financially from their quality management and reduced risk profile. On the other hand, of course, a bank that is deemed to take excessive risks will receive higher bids from prospective monitors, who will be reflecting the greater monitoring risks.

After an initial investigation, the MGs interested in monitoring a particular bank will bid for that bank's examination fee during the succeeding year, specifying the schedule for its examination and the information it will require. In most cases, the bank will accept the lowest bid or the one with the fewest restrictions or demands. Although the bank will be interested in reducing the cost of its monitoring, choosing the least expensive MG may not

be the most effective strategy in the long run, because the bank will also have to pay the cost of its private deposit insurance, described below.

Following through on the idea that the banking industry's capital—and not a government program—should be what backs the deposit insurance system, groups of banks will form syndicates to bid for an individual bank's deposit liability. In other words, the deposit insurance risk of any bank will be "acquired" by a syndicate of banks in much the way risks are sold to (or bought by) insurance consortia on the floor of Lloyd's of London.

For assuming the deposit insurance risk of a bank, the bank syndicate will receive a payment from the insured bank. The payment will vary according to the risk of default. One of the key elements of risk will the quality, diligence and experience of the MG that is the bank's monitor. In general, banks that are well managed, and pay low fees to the MG for monitoring will pay a low premium to the deposit insurance syndicate. Banks with a weak or inexperienced monitor will be required to pay a higher insurance fee to the syndicate. It should be possible for the premium on an insurance contract to be raised on an interim basis where the insured bank has missed certain risk parameters during a year.

All U.S. banks will also agree to "stop-loss" provisions so that the banks that are members of insurance syndicates that suffer significant losses would not be seriously weakened by a catastrophic loss. This means that the banks that initially assumed the risk would be protected by an agreement of all banks that no bank in a loss protection syndicate would lose more than a specified percentage of its capital in the event of a catastrophic collapse of one or several insured banks. If the losses from a catastrophic event reach that level, all banks will be required to assist the syndicate or syndicates that have suffered the losses. These cases would likely be very rare, but a stop-loss provision would assure that a major collapse would not have unusual systemic effects.

In this system, a bank like SVB would have faced additional monitoring fees from its MG as its condition declined or its risks increased. Its problems, as detailed in the GAO report described above, would be promptly reported by its MG to the insurance syndicate, and would probably have resulted in an increase in its insurance fee.

If a bank could not reach agreement on a monitoring fee with an MG, or could not find another MG and insurer syndicate within a limited period of time, it would have to close. No bank or S&L would be permitted to operate without an MG and a contract with an insurance syndicate.

CONCLUSION

Again, Bill Isaac's summary is applicable. "It's clear from the three major banking crises in the past 40 years [(1974-1976, 1980-1992, and 2008-2009)] that we have not achieved [the necessary] balancing act. None of these crises occurred because of lack of regulatory authority but rather the failure

of regulators to use their authority effectively to rein in excessive speculation by financial institutions. . . . Ineffective regulation is worse than no regulation because it gives citizens a false sense of confidence that government is protecting them."[40]

The relevant question about the current U.S. system of supervising and regulating banks and S&Ls is whether there is a better way. As it's done now—through various agencies of the federal government—has left the people and businesses of the United States, the richest and most advanced country on Earth, with regular financial crises, personal financial losses, and needless disruptions in their lives and activities. These have continued over the 110 years since the Federal Reserve was established. Perhaps it's because of the nature of banking—perhaps there just is no better way—but that seems highly unlikely.

Let's consider something as essential as the food delivery system for the 350 million people in the United States. The government has no significant role in this, except to assure safety through laws and periodic inspections, but Americans almost never find themselves without available nourishment, anywhere in the country, any day of the week, and any time of the year. The delivery of oil and gas for home heating continues without any government role, and the same is true of gasoline for automobiles and electricity for lighting streetlights and homes and powering manufacturing. Even Elon Musk's Space-X has been putting more satellites into Earth orbit than NASA.

All these essential services work day-to-day without any government role, and without any significant failure or disruption that affects more than the particular customers of a failing institution. Why can't this work for banking?

The answer is that it can. The difference between all these services and banking is that banking is heavily regulated and controlled by the government, while the rest run on private incentives. It may be that banks require supervision, but if so, incentives can be built into supervision so that banks can be compelled to act safely and soundly the same way that other private sector suppliers of goods and services do. It only takes a bit of imagination and the will to try.

In this paper, I have suggested how such a system might be run. It's what is called high level in the sense that no one has gone down into the details to make sure it functions properly, but once a monitoring group is responsible for the safety and soundness of a bank, there is no reason to suppose that it will not respond to the same incentives that keep the food, electricity, gas and other systems working without government management.

This would be a radical change, to be sure, but no one can deny that the current system isn't working.

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40 *See* Isaacs, *supra* note 5 (on file with author).

LOOKING FORWARD BY LOOKING BACKWARD: THE FUTURE OF CONSUMER FINANCE AND FINANCIAL PROTECTION

Todd J. Zywicki[*]

It is often remarked that some seventy percent of the economy is consumer goods and services, from housing, televisions, books, and cell phones to massages, vacations, and playing "Call of Duty." But behind that day-to-day experience rests a complex network of largely unobservable payments, credit, and enforcement of contracts that most consumers take for granted until something goes wrong. Put simply, the modern American economy and the prosperity of every household in America rest on the evolving foundation of consumer finance.

The resiliency of the consumer financial system was most recently exhibited with the remarkable adjustment of the entire American economy to an effectively digital environment in the span of just a few weeks during the 2020 COVID-19 pandemic and government response to it. Restaurants and other consumer businesses shifted online virtually overnight, accelerating a decade's worth of financial innovation and uptake into the span of a few months. Student loan debt, which hardly existed 30 years ago, is now the second-largest tranche of consumer debt in the economy trailing only mortgage credit and surpassing auto loans and credit cards. Checks, a ubiquitous payment method just two decades ago, are virtually nonexistent and likely to be phased out in the near future. And the rise of the digital economy and digital payments brings transformative potential for improving choice, competition, and financial inclusion, but also unprecedented risks to civil liberties and data security.

What does the future hold for consumer finance and consumer financial protection? While the modern challenges and opportunities are new, the underlying dynamic of the co-evolution of technology and consumer finance is not. And prior eras can also provide insights as to how to adapt the consumer financial protection system to these evolving opportunities and threats. Past experience teaches that a failure to act swiftly and sensibly in response to evolving consumer financial technology and consumer preferences can be harmful to consumers and the economy. But the future holds both more promise and peril in consumer finance than perhaps any time before—the opportunities and challenges presented by the Internet, electronic payments,

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and the seamless integration of financial services with everyday life through the "internet of things," social media, commuting, and digital payments. Modern consumer finance promises a degree of global convenience and ubiquity in financial services that empowers consumers. At the same time, the penetration of digital payments presents novel risks to data security and, most menacing of all, the growing use by government and private power of leveraging the digital payments and banking systems to wage a guerilla war on constitutionally-protected rights such as free speech, freedom of religion, gun rights, and even criminal procedure protections. Moreover, the entanglement of the vast and vaguely defined powers of the regulatory state with the provision of consumer financial service to date has proven difficult for courts to police, leading to potential infringements on constitutional values.

This modest paper will only touch the surface of many of these issues but will present a framework for illustrating how consumer financial regulation has evolved in past eras to address changes in technology and consumer preferences. The theme of this evolution of consumer financial protection is simple, but powerful—consumer financial protection regulation in both structure and substance must adapt to changes in technology and the challenges those present. The consumer financial ecosystem consists of hundreds of millions of consumers in the United States alone, using financial services to make their lives better. And in every era and every time there have been consumers (just as there are businesses and governments) who overuse credit and get in trouble. But the historical story is largely a benign one—consumers in general learn to use consumer credit not only responsibly but to make their lives better. At the same time there have always been elites and government regulators who have bemoaned these developments and tried to stand against the tide through paternalistic and misguided regulations that invariably are seen to harm the people they allegedly are intended to help.

But the tide of hundreds of millions of consumers trying to make their lives better day-to-day has proven irresistible. And historically after much pain and struggle the regulatory system has come to recognize these realities. Change has not come easily though, as entrenched interests and ideological predispositions have stood against the change only to usually be overwhelmed. Change in the regulatory framework has tended to come abruptly and decisively in response to a final recognition of new realities, not gradually over time. As economist Vernon Smith put it in his cover blurb to my co-authored book, *Consumer Credit and the American Economy*, the history of consumer financial regulation reveals "an emergent order of behavioral and parallel institutional rules, with no commanding identifiable leader."[1]

Thus, while the particularities of the evolutionary process of consumer finance and its "parallel" institutional rules are unpredictable, the general

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[1] *See* THOMAS A. DURKIN, GREGORY ELLIEHAUSEN, MICHAEL STATEN & TODD J. ZYWICKI, CONSUMER CREDIT AND THE AMERICAN ECONOMY (2014) (cover blurb by Vernon Smith).

direction of change is predictable.[2] Technological innovations that reduce transaction costs and enhance competition and choice for consumers are resisted at first by the forces of the status quo that cling to the old way of doing things both in business and regulation. Eventually, however, this tension snaps the wire, leading to a need to modernize the consumer financial protection system to reflect the changes of consumer reality.

For simplicity's sake we can identify three basic eras of consumer finance and consumer financial regulation: The pre-modern era beginning around the turn of the Twentieth century that featured the early development of consumer finance to meet the needs of growing class of urban wage-earners; the modern era beginning in the post-World War II era as high-quality, reasonably-priced financial services became increasingly accessible to middle-class consumers in a national market; and the post-modern era, where we stand today, looking forward to the digital economy in a world without geographic constraints. Each of these eras calls forth unique challenges and opportunities for consumer behavior. But one constant remains—efforts to try to steer consumers in directions preferred by regulators and other interests have largely failed and, indeed, proven counterproductive.

At the same time, as Smith's cogent observation reflects, these changes in technology and consumer behavior have called forth parallel institutional changes: notably the migration of consumer financial protection authority in the U.S. from local governments to the national government, and today, the unique challenge associated with the Internet and digital technology platforms.

The purpose of this article is to illustrate this historical arc. I will not provide an in-depth analysis of each of these three eras, which I have done elsewhere,[3] but will use these eras to illustrate the general co-evolutionary arc with an eye toward identifying a framework to guide the structure of the future rules and institutions of consumer financial protection.

I. THE PRE-MODERN ERA OF CONSUMER FINANCE: THE RISE OF URBAN WAGE ECONOMY

For most of human history, consumer finance was largely nonexistent for one obvious reason—the concept of a consumer economy was largely nonexistent. Most individuals worked from sunup to sundown farming, either eating what they produced or bartering for other agricultural commodities (such as grain for eggs). Similarly, most goods that we today think of as "consumer goods" such as clothing or furniture, were made at home. The

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2 *See* Friedrich August von Hayek, *The Pretence of Knowledge*, 79 AM. ECON. REV. 3, 5–7 (1989) (Nobel Memorial Lecture, Dec. 11, 1974).

3 *See generally* DURKIN, *supra* note 1; CONSUMER FINANCIAL PROTECTION BUREAU, REPORT OF THE CONSUMER FINANCIAL PROTECTION TASKFORCE ON FEDERAL CONSUMER LAW (2021) (hereinafter, "CFPB TASKFORCE REPORT").

idea that ordinary working people could earn wages or generate a surplus that could be exchanged for consumer goods was largely unknown.

The wealthy, by contrast, held land and other assets that could be offered as security to acquire credit. Indeed, many Southern plantation owners were in chronic debt to creditors to maintain their large estates and luxurious consumption habits. But non-elites had little access to credit and little need for it.

This reality changed with the Industrial Revolution. Peasants left the countryside to work in factories for wages. Instead of growing their own food and making their own clothes, they instead exchanged their labor for wages which they then used to purchase goods previously produced at home. In the United States these dynamics were especially pronounced. Millions of penniless immigrants and farmers, most with little property but strong backs and an equally strong work ethic, flooded into American cities looking for work in the wage economy. Industrial work brought with it new economic opportunities. Mass production of reasonably-priced consumer goods such as clothing, hardware, radios, and others made it possible for workers to seek and obtain a great array of useful consumer goods. But at the same time, it also brought new challenges—the need to pay rent, acquire consumer goods (such as food, clothing, and furniture), and to deal with the challenges of urban industrial life, such as novel illnesses and cyclical unemployment.

The prosperity of the post-Civil War era, the emergence of a middle class, and the growing fortunes of many ordinary Americans brought with it new desires for consumer goods. Entrepreneurs responded by allowing creditworthy workers to buy consumer goods such as carpets, clothing, pianos, sporting goods, and other goods "on time."[4] Since they mostly had little in the way of assets they could post as collateral for a loan, the installment loan arrangement allowed ordinary Americans to purchase goods and pay for them out of their most valuable asset—their future wages.

Access to "cash credit," however, remained limited and expensive, primarily because of archaic usury law and others. Consumers who needed cash for a medical bill or to pay rent were stymied by restrictive usury ceilings that dated back centuries and served as an accompaniment to "sumptuary" laws that were intended to restrict what was considered excessive consumption. This was especially the case with respect to members of the elite and wealthy class, who sneered at the pretenses of ordinary wage-earners seeking to raise their standard of living by acquiring new consumer goods.

Theorists of the time, including none other than Adam Smith himself, criticized this use of consumer credit.[5] Speaking for the conventional wisdom of the time, Smith distinguished between two types of credit—productive loans to "sober" individuals, i.e., low-risk, responsible borrowers, on one hand, and loans to "prodigals and projectors," such as risky speculators, as

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[4] *See* DURKIN, *supra* note 1, at 88–90.

[5] Jeremy Bentham's famous tract, *In Defense of Usury*, was a response to Smith's justification of usury laws. *See generally* JEREMY BENTHAM, IN DEFENSE OF USURY (1787).

well as loans to fund consumption on the other hand. Because the latter borrowers were inherently riskier, Smith assumed they would be required to pay a higher rate of interest. Usury ceilings, it was thought, would provide a means of dampening this unproductive activity by making it unaffordable to lend to those problematic borrowers.[6]

Smith's analysis, however, ignores a key point—since the beginning, the overwhelming use of consumer credit has been for what should be considered *productive* purposes, namely investments in household consumer durables. Although styled "consumer" goods, the goods acquired with these loans are in the nature of *capital* goods, not mere consumption. This is most obvious in the case of residential mortgages, which enable a consumer to forego monthly rent payments while living in the good and to acquire the good's equity value at the end of the loan term. Student loans are equally obvious—it makes little sense to require an individual to work in low-paid unskilled jobs in order to save up enough money to attend college and to get a college degree. Student loans allow a consumer to borrow against his or her future income to acquire human capital skills today—a future income that will be *higher* as a result of attending college, leaving the consumer with a surplus after the loan is paid off.

But it may not be appreciated that most consumer durables are also very valuable capital investments. A refrigerator, sofa, television, stove, microwave, bed, etc.—although consumer goods, all of these are actually better understood as capital goods that provide extremely high value to a consumer immediately and for which it makes sense to advance the time of acquisition. Consider, for example, the humble clothes washing machine—acquiring a washing machine early in one's adult life will likely be one of the most productive investments one can make, as opposed to schlepping to the laundromat every weekend with a pocket full of quarters. In light of the time, inconvenience, and cost associated with washing clothes at a laundromat, a washing machine may be among a household's most high value investments.[7]

As a result, it is rational behavior for consumers to shift the timing of purchase of consumer durable goods through the use of consumer credit, even at relatively high rates of interest. Hence it is not surprising that installment credit to acquire consumer durables emerged early on in the transition to a consumer, wage-earner economy. To be fair to Smith, however, this logic that most consumer credit is for the acquisition of capital goods rather than consumption, remains elusive to most economists today.

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6 *See* ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 300 (Cannan, ed. 1776); *see also* Joseph M. Jadlow, *Adam Smith on Usury Laws*, 32 J. FIN. 1195, 1195–96 (1977). Jonathan Diesel has argued that Smith actually opposed usury restrictions but argued in an esoteric fashion for their retention for political reasons. *See generally* Jonathan Diesel, *Adam Smith on Usury: An Esoteric Reading*, 184 J. ECON. BEHAV. & ORG. 727 (2021). I do not attempt to resolve that debate here, simply to observe how widespread support for usury restrictions have been through history.

7 *See* CFPB TASKFORCE REPORT, *supra* note 3, at 175–76.

Cash credit can be analyzed through more or less the same lens. Borrowing money, even at a relatively high rate of interest, is rational depending on what the alternative is. If the alternative is eviction, foregone medical care, or your child being thrown out of day care, the value of a short-term cash loan can be very high. Magical thinking that the consumer should just "save more" doesn't meet the needs of young consumers with minimal assets and entry-level wages faced with urgent expenses.

More generally, consumer credit use follows a life-cycle model. Early in an individual's life, a consumer has a high demand for credit and a low supply. This is most obvious in borrowing to acquire an education. But once a young person graduates from college, he then has to move to a new city, get established, find a place to live, acquire furniture, a work wardrobe, and probably a car, and a variety of other high-value acquisitions. At the same time, he has the lowest access to the supply of credit in his life—he will have minimal savings (and will often be technically insolvent if he has student loans), the lowest wages of his working life, a minimal and relatively thin file credit score, and no valuable assets. Eventually, he moves on to get married, start a family (which is far from inexpensive), buy a house and incur all of the expenses associated with living, including clarinets, braces, and soccer cleats.

As our now-happily married hypothetical house-owning father matures, this dynamic changes. He goes from being a *borrower* early in his adult life to becoming a *lender*. At the same time he pays down the debt acquired earlier in his lifecycle, the urgency and value of his investment needs declines. He now has a house, a car, a refrigerator, a wardrobe, a stove, etc. His education is complete. It is conventional to refer to this period of life as "saving" money, but it should not be overlooked that in fact one is not saving, one is *lending* and investing in others. Banks are financial intermediaries that convert pools of excess funds into loanable funds to invest in other individuals and companies through mortgages, car loans, and the like. Investments in financial assets such as equities or fixed-interest investments, such as through mutual funds or retirement accounts, serve a similar purpose. The bank borrows money from you and bundles it with other people's money to lend the money to other people and pays interest to use that money.

Finally, as he stops working and eases into retirement, he begins to draw down on this lifetime of accumulated savings and wealth. Empirical evidence confirms the intuition—as one ages, purchases on consumer durables (such as cars, clothes, and furniture) decline and purchases on true consumption (mostly health care but also leisure activities such as travel) tend to rise. Retirement also shifts the slope of an individual's budget constraint between time and money—financial expenditures drop as individuals engage in more time-intensive activities such as preparing more meals at home and doing their own lawn work and home maintenance, and eliminating many of the expenses associated with working, such as commuting costs, lunches, and wardrobe purchases, and laundering.

Pawnbrokers provided one major source of consumer credit to lower-income consumers. Pawnbrokers had an ingenious way of evading usury restrictions—by simply offering a lower price for the goods that were pawned, thereby implying a lower interest rate than otherwise would have been the case. (Retailers similarly marked-up the prices of the goods they sold to offset their inability to charge a market rate of interest on purchase-money installment loans).

But pawn shops were of limited usefulness because they required consumers to actually own property that was actually of value if resold (which many did not) and then they would be required to part with that property in order to acquire the loan. Moreover, because the property is usually of minimal value to anyone other than the owner, the value offered for the property is small, other than items such as jewelry.

Most wage earners entered into unsecured loans and promised to pay off the loan from their stream of future wages, much like modern installment or payday loans. Needless to say, these loans were risky and also incurred high administrative and underwriting costs relative to the modest size of the loan. Because of the unreasonably low usury ceilings in effect at the time, access to these loans from legal providers was virtually nonexistent.

Faced with an urgent need for cash that they were unable to obtain because of usury laws and other restrictions on lending, desperate wage earners turned to illegal lenders to meet their needs. City workers, who were considered good customers because of their relative job stability, were especially heavy users of illegal lenders. One economist estimated that in 1911 approximately 35% of New York City employees owed money to an illegal lender. Former Federal Reserve Chairman Alan Greenspan once referred to the plight of city-dwellers in that era as one of "virtual serfdom."[8]

During the 1910s and 1920s the Russell Sage Foundation launched a project of research and political advocacy to study the needs of wage-earners for credit and the effects of usury ceilings and other regulations on these consumers.[9] They pointed particularly to the adverse effects of usury ceilings in blocking access to legal lenders and thereby driving consumers to illegal lenders.

The result was the proposal for the Uniform Small Loan Law, which created a template for regulation of small loans.[10] The USLL was based on a simple premise—while regulators can try to eliminate the supply of legal credit to consumers, they cannot limit demand, especially by wage earners. Supporters of the new law, particularly the Russell-Sage Foundation,

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8 Remarks by Chairman Alan Greenspan, *Consumer Credit and Financial Modernization* 2 (Oct. 11, 1997), https://www.federalreserve.gov/boarddocs/speeches/1997/19971011.htm.

9 *See* Elisabeth Anderson, *Experts, Ideas, and Policy Changes: The Russell Sage Foundation and Small Loan Reform, 1909-1941*, 37 THEORY & SOC'Y 271, 275 (2008).

10 *See* LOUIS N. ROBINSON & ROLF NUGENT, REGULATION OF THE SMALL LOAN BUSINESS 113–17 (1935) (Russell Sage Foundation); Rolf Nugent, *Three Experiments with Small-Loan Interest Rates*, 12 HARV. BUS. REV. 35, 35–36 (1933).

supported a more realistic interest rate ceiling (36-48% APR) and increased competition as the best means to meet consumer demand. In a phenomenon that has reoccurred through history, an unlikely coalition of Baptists and Bootleggers opposed the reforms, as upper-class elites paternalistically sought to prevent workers from gaining access to credit, while the illegal lenders fought to maintain their profitable stranglehold on desperate workers and to prevent competition from legal sources.

The USSL was a success. Illegal lenders were driven from the market and wage-earners for the first time found access to credit on competitive terms, transparent prices, and without the unsavory collection methods they confronted under the old system. During the 1920s, use of consumer credit more than doubled.[11] Consumers increasingly used credit to purchase consumer durables, including furniture, pianos, radios, encyclopedias, sporting goods, and others. The emergence of auto financing in the mid-1920s through the creation of the GMAC auto financing plan, played a particularly large role in mainstreaming the use of consumer credit for consumer durables.[12] Previewing rhetoric that would reoccur through American history, elites criticized this growing access to credit for middle class Americans, arguing that it allowed consumers to live beyond their means, encouraged "conspicuous consumption," produced financial ruin for families, and generated macroeconomic instability.[13]

II. THE MODERN ERA OF CONSUMER FINANCE: THE GREAT DEPRESSION AND THE RISE OF THE MIDDLE CLASS

In yet another preview of later criticisms of consumer credit, some commentators argued that one cause of the Great Depression and subsequent economic distress of American households was an overextension of consumer credit. Retailers and other lenders seduced consumers into overconsumption

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11 *See* MARTHA OLNEY, BUY NOW, PAY LATER: ADVERTISING, CREDIT, AND CONSUMER DURABLES IN THE 1920S 86–91 (1991); *see also* Martha L. Olney, *Avoiding Default: The Role of Credit in the Consumption Collapse of 1930*, 114 Q. J. ECON. 319, 321 (1999).

12 Ford responded with its own financing plan—an opportunity to buy a Ford on layaway, i.e., the consumer could send money to Ford every month and eventually accumulate enough of a balance to purchase a car. This peculiar arrangement reflected in part Henry Ford's dislike of consumer credit (as a result of negative family experiences growing up) but also Ford's notable anti-semitism which led him to see consumer credit as a plot by stereotypical "Jewish bankers" to exploit hard-working Americans by luring them into living beyond their means, another rhetorical trope that has recurred repeatedly in discussions about consumer credit through American history.

13 *See* LENDOL CALDER, FINANCING THE AMERICAN DREAM 158 (2001). Thorstein Veblen's famous book *The Theory of the Leisure Class* was published in 1899. In that book he claimed to have identified a new form of "conspicuous consumption," whereby people purchase consumer goods to gain relative status with their neighbors. Veblen argued that in part this conspicuous consumption was funded by excessive borrowing by consumers living beyond their means.

through debt. Of particular concern were the emerging class of small-loan licensed lenders under the USSL, that supposedly were engaged in overzealous and cutthroat competition for customers, leading them to lend ever-greater amounts to ever-riskier borrowers, hoping to "hook" them on loans and drag them deeper into debt. In response, the revisions of the USSL in the 1940s included a new requirement that provided that new licenses should be granted only after applying for a certificate of "convenience and advantage" and establishing that the local market was not being served adequately by the existing lenders.[14] Like the emergence of requirements in other markets (such as healthcare) the logic that underlay this concept was that small loan lending was a type of public utility that featured a particular minimum efficient scale of operation. As intended, these rules reduced competition, leading to higher prices and less access for consumers.

At the same time, many legislatures and others saw the Great Depression as an opportunity to reinstate the punitive usury ceilings that had been a pervasive feature of law in the pre-industrial era. The results were sadly predictable and tragic: By the 1960s, illegal loan sharking was ubiquitous, especially in urban America, where organized crime preyed on wage-earners using violence and intimidation to support their collections.

The economic impact of renewed usury regulations was especially devastating in minority urban communities, where many residents lacked established credit records and the restrictions on competition created an economic environment ripe for indulging discriminatory preferences by lenders that lacked strong competitive checks.[15] Residents of urban communities, referred to as "ghetto" communities in the argot of the time, sadly were forced to rely on so-called "ghetto shops" where retailers sold overpriced goods of shoddy quality to low-income consumers who were trapped into relying on these merchants because they were the only providers of credit to purchase household durables.

To illustrate the point, consider the case of *Williams v. Walker-Thomas Furniture*, a case that is a fixture in law school curriculums.[16] *Williams* is famous for its holding that the contract terms offered by the furniture company were deemed "unconscionable" by the court in that case and nullified. What is not mentioned by the court in that case, however, is that there *was not a single consumer finance company* operating in Washington, DC, at that time. Why? Because the District's unreasonably low usury law made it impossible for personal finance companies to operate and provide credit on

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14 *See* FRANK BROOKES HUBACHEK, ANNOTATIONS ON SMALL LOAN LAWS: BASED ON THE SIXTH DRAFT OF THE UNIFORM SMALL LOAN LAW 54 (1938) (publication of Russell Sage Foundation) (criticizing "tendency for excessive competition to increase costs of lending")*; see also* Anne Fleming, *Anti-Competition Regulation*, 93 BUS. HIST. REV. 701, 702–03 (2019).

15 CFPB TASKFORCE REPORT, *supra* note 3, at 558–84.

16 Williams v. Walker-Thomas Furniture Co., 350 F.2d 445 (D.C. Cir. 1965).

competitive terms.[17] The 1964 codification of the Washington, DC consumer credit code defined as "usury" any verbal contract to pay an interest rate greater than 6 percent per year or a written contract at greater than 8 percent per annum.[18] As a result, Ms. Williams and many others like her, were dependent on retailers to provide them credit to be able to by household goods and appliances. And while "ghetto" retailers also were limited in the interest rates they could charge, they could evade those limits by simply marking up the price of the goods they sold, thereby burying the cost of credit in the price of the goods. Needless to say, however, this practice made credit pricing much less transparent and increased the opportunities for discrimination. The growing frustration of minority urban populations with the perceived predatory practices of so-called "ghetto" retailers has been identified as one of the underlying causes of the urban unrest and riots of the late-1960s.[19]

As was the case half a century before, usury ceilings were supported by a coalition of Baptists (elite, self-proclaimed consumer advocates) and Bootleggers (organized crime and other loan sharks) who benefited under the prevailing system. As Economics Nobel Laureate Paul Samuelson observed in 1969: "For fifty years the Russell Sage Foundation and others have demonstrated that setting too low ceilings on small loan interest rates will result in drying up legitimate funds to the poor who need it most and will send them into the hands of the illegal loan sharks. History is replete with cases where loan sharks have lobbied in legislatures for unrealistic minimum rates, knowing that such meaningless ceilings would permit them to charge much higher rates."[20] Similarly, in 1964 New York's Senator-elect Robert F. Kennedy urged the state legislature (which was investigating organized crime operations in the state) that the most effective way of reducing the influence of organized crime would be to "alter[]the state laws on usury so an insolvent

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[17] *See* REPORT OF THE NATIONAL COMMISSION ON CONSUMER FINANCE, CONSUMER CREDIT IN THE UNITED STATES 180 (Dec. 1972) (noting that there were no small loan companies operating in Harlem or the District of Columbia at that time as a result of excessively low interest rate ceilings and other legal barriers to entry); *see also* CFPB TASKFORCE REPORT, *supra* note 3, at 565. I have not been able to determine whether the Washington, D.C., regulatory code at the time also placed formal barriers to entry such as Certificate of Convenience and Necessity requirements. Professor Duncan Kennedy recently responded to law and economics criticisms of the *Williams* decision by arguing that inner-city credit markets were "oligopolistic" at the time of *Williams*, yet he fails to acknowledge that the lack of competition was the result of the District's harmful consumer finance regulation that made competition by small-loan lenders infeasible. *See* Duncan Kennedy, *The Bitter Ironies of* Williams v. Walker-Thomas Furniture Co. *in the First Year Law School Curriculum*, 71 BUFFALO L. REV. 225, 250–54 (2023). Anne Fleming's in-depth analysis of *Williams*, on which Kennedy relies extensively, is likewise silent on this reality. *See generally* Anne Fleming, *The Rise and Fall of Unconscionability as the "Law of the Poor,"* 102 GEO. L.J. 1413 (2014).

[18] *See* 78 Stat. 676, Pub. L. 88-509, Subtitle II, Chapter 33—Interest and Usury, Usury Defined §28-3303 (Aug. 30, 1964).

[19] *See* LOUIS HYMAN, DEBTOR NATION: THE HISTORY OF AMERICA IN RED INK 150–51 (2012).

[20] Paul Samuelson, Testimony Before the Massachusetts State Legislature Judiciary Committee on the Uniform Consumer Credit Code 164 (Jan. 29, 1969).

person who needs money for legitimate purposes might borrow it at rates that were not exorbitant" rather than being forced to turn to the mafia for funds.[21]

These two factors—the resurgence of loan sharking and the persistent poverty and economic distress of American cities—combined with four other factors to create an environment ripe for reform of the consumer financial system. First, the growing economic power of American women and their entry into the workforce in the 1970s created a push to reform traditional practices by banks that discriminated against married women in the granting of credit.[22] In particular, the emergence of the feminist movement, led by professional women with economic and social power, pushed for regulatory reform. Second was the rise of comprehensive credit bureau reporting and—even more important—the development of "credit scoring" models, such as Fair-Isaac (FICO) that enabled a more objective assessment of a borrower's credit-worthiness than the subjective (and often discriminatory) systems of the past. Third was a general wave of regulatory reform designed to sweep away many of the old restrictions on competition that dated to the Progressive Era and New Deal and to replace it with a more competitive market framework, a development from which banking regulation would not be spared.[23] Finally, and perhaps most important, was the rise of a *national* consumer finance system that produced a need for a greater national consumer financial regulatory framework.

At the same time, it is important to recognize that, for leading thinkers of the age, these factors were intertwined—for example, it was recognized that a major cause of the persistent patterns of improper discrimination in lending markets was the presence of usury ceilings and other regulations that dampened competition and thereby enabled discrimination to occur without economic penalty.[24] Moreover, the primary means for which reformers advocated to increase competition and consumer access to credit and reduce discrimination was the increased reliance on nondiscriminatory means of

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21 *Inquiry Is Begun on Loan Sharks: Underworld's Investment in Racket is Put at Billion*, N. Y. TIMES at 1 (Dec. 2, 1964) (describing letter from Senator Robert F. Kennedy to New York State Investigations Commission that recommended raising usury ceilings so that borrowers would not have to turn to loan sharks).

22 There is little evidence that banks discriminated against single women. But when women married their credit histories were merged into their husbands'. This was problematic in its own right, of course, but created even greater problems if the couple was later divorced, which was a growing social phenomenon at the time. *See* discussion in HYMAN, *supra* note 19, at 163–74.

23 These developments culminated in the Riegle-Neal Act that led to the elimination of restrictions on interstate branch banking.

24 For example, one notable study found that following banking deregulation, more women became executives at banks than prior, and overall salaries of bank officials declined, consistent with the hypothesis that anti-competitive banking regulation enabled discrimination and inefficiency by banks. Sandra E. Black & Philip E. Strahan, *The Division of Spoils: Rent-Sharing and Discrimination in a Regulated Industry*, 91 AM. ECON. REV. 814, 816 (2001).

assessing creditworthiness, such as credit scores, rather than the old subjective means.

With respect to consumer financial regulation, of particular relevance is the growth of a national consumer credit economy. This was in large part technological—the declining cost of long-distance telephone calls increasingly made it easier to offer credit and to collect on debts across interstate lines and limited the abilities of state and local enforcement. As a result, one of the first areas of federal regulation involved regulations on debt collection, such as the Fair Debt Collections Practices Act and related regulations. In addition, many traditional local department stores and retailers were displaced by large national department store chains such as Sears, JC Penney's, and Woolworths. These large department store chains eventually developed centralized credit processing and collections facilities supporting outlets across the country, further creating a more national market for credit.

Most significant in driving the demand for consumer credit was the great migration of Americans to the suburbs in the post-World War II era.[25] This migration was fueled by the use of consumer credit. Most obvious, the home ownership rate exploded, as consumers moved from rented housing in the city to new, mortgage-financed homes in the suburbs. But that was just the beginning. Relocating to the suburb required purchasing a car—usually with a car loan (and then later, a second car)—along with a bedroom set, dining room furniture, and modern appliances such as a refrigerator, stove, and washing machine. Needless to say, all of these accessories were bought "on time," usually through either a finance company loan or directly through credit extended by the retailer. Use of consumer credit grew rapidly and concomitantly with home ownership rates and the migration to the suburbs as consumers "financed the American Dream."[26] Indeed, available data indicates that the overall level of household non-mortgage debt relative to income or assets has remained more or less steady since the 1960s but has simply changed composition as revolving credit card debt has over time supplanted credit supplied by retailers and personal finance companies.[27]

Just as the Russell-Sage Foundation catalyzed research and advocacy in the 1920s for reform, the National Commission on Consumer Finance (NCCF) served a similar role. Originally created by President Lyndon Johnson and inherited by Richard Nixon, the NCCF was a bipartisan, blue-ribbon

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[25] *See* Todd Zywicki, *Your Credit History (the Accurate Version)*, L. & LIBERTY (Oct. 20, 2014), https://lawliberty.org/your-credit-history-the-accurate-version/.

[26] To borrow the title from Lendol Calder's marvelous book on consumer credit in America. LENDOL CALDER, FINANCING THE AMERICAN DREAM (2001).

[27] *See* DURKIN, *supra* note 1, at 86–87. Thus, it is simply false to claim as then-Professor Elizabeth Warren did, that prior to the 1980s and widespread access to credit cards, consumers preferred to save up and "pay cash" for purchases. *See Interview with Elizabeth Warren*, *Secret History of the Credit Card*, FRONTLINE (No. 23, 2004), https://www.pbs.org/wgbh/pages/frontline/shows/credit/interviews/warren.html. Similarly, and more importantly, the current debt ratio has remained more or less constant since the 1980s and reflects this same substitution. But for the massive increase in student loan debt, the consumer debt ratio for the typical household would be significantly lower today than forty years ago.

commission tasked with studying and modernizing the consumer financial protection laws and regulations to meet these challenges of the modern era. The NCCF Report was withering with respect to economically archaic ideas such as usury ceilings and paternalistic notions of consumer financial regulation. Instead they called for a system based on consumer sovereignty, competition, choice, and disclosure-based regulation designed to promote competition and consumer choice. Indeed, the NCCF went so far as to call for national preemption of state usury laws and the creation of a national charter for personal finance companies that could lend to consumers without the interference of state usury laws and other anti-competitive laws.

The NCCF both captured and accelerated the intellectual and policy zeitgeist of the era, producing a wave of deregulation and regulatory reforms designed to promote competition and consumer choice. Moreover, it promoted financial inclusion, both through the adoption of pro-competitive reforms (such as the greater use of systems like credit scoring in granting credit) as well as the elimination of anti-competitive barriers such as usury restrictions and limits on branch banking that blocked inclusion and created conditions favorable to discriminatory practices. Although the NCCF failed to gain federal preemption of usury ceilings or the recognition of a personal finance company national bank charter, this was largely obviated by the Supreme Court's unanimous decision in *Marquette National Bank v. Bank of Omaha*[28] in 1978, which effectively deregulated credit card interest rates (initially) but which later led to a more general deregulation of interest rates (and later other terms and conditions) of other consumer financial products offered across state lines by banks.

The result of the regulatory framework ushered in by the legislative, regulatory, and judicial reforms of the 1970s were hugely beneficial to American households. Loan sharking largely declined and competitive forces led to an explosion in consumer access to high-quality financial services such as credit cards, auto loans, and the like. The replacement of checks and cash by debit cards and other electronic payments systems led to an unprecedented growth of access to bank accounts and later, ancillary services such as automated overdraft protection, which traditionally had been limited to a select few. While challenges remained, in terms of inclusion and access, as well as legacy effects of discriminatory federal policies in the past, the framework established in the 1970s grounded in competition, choice, and a minimum of substantive regulation created a framework for an innovative and high-quality financial system that served most consumers well. Moreover, middle-class consumers were particular beneficiaries of this system, having access to a wide array of credit and banking services on competitive and transparent terms that enables us to shop, travel, and otherwise live life easily and seamlessly.

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[28] 439 U.S. 299 (1978).

III. THE 2008 CRISIS AND THE FUTURE OF CONSUMER FINANCIAL REGULATION

To summarize the argument so far, prior to the late-19th century the American economy was largely agricultural and the average American's need for consumer credit was limited. During this period, usury ceilings were widespread under archaic and paternalistic theories supported by elites that sought to limit access to credit for ordinary people. At the same time, by restricting the ability to lend to ordinary workers, these rules essentially subsidized borrowing by elites who held land and other collateral to support their loans and who possessed the personal connections and reputation to be able to gain access to loans. The growth of American cities and the wage economy in the late-19th century produced the pre-modern era of consumer credit. The migration of farm workers and immigrants into the city created a need for credit among wage-earners that ran up against these archaic restrictions on lending, depriving wage earners of access to finance and driving them to loan sharks.

This led to the movement for reform spearheaded by the Russell-Sage Foundation in the 1920s, an effort that culminated in the adoption of the Uniform Small Loan Law, which increased permissible interest rate ceilings and promoted competition as the most effective way to empower and protect consumers. Following the Great Depression, however, many states began to ratchet down usury ceilings again and to adopt other anti-competitive regulatory schemes. These rules proved punishing to lower-income Americans, especially urban minorities. Middle Class Americans, however, were undertaking the great migration to the suburbs during this era, fueling a demand for consumer credit to purchase and establish their new households. This led to much-needed reforms to address the new challenges presented by the growth of an increasingly national consumer finance economy. Technological developments, including a declining cost of long-distance telephone service as well as computerized credit scoring systems, led to an explosion of competition and a growing need for federal regulation.

This brings us at last to the current and future era of consumer financial regulation. What lessons can we learn about the future from what has come before?

Most obvious, just as technology changed consumer finance in the mid-20th century, technology is once again fundamentally transforming consumer finance today. The rise of the Internet has not only moved us to a world of *national* consumer finance markets (as was the case at the time of the NCCF Report) but what amounts to a global, or effectively, "nowhere" model of consumer finance. Ubiquitous use of the Internet to solicit and provide financial services, disclosures delivered on smartphones and attested by electronic signatures, and the ability to instantaneously shop and compare competing offers for provision of services, all challenge the 1970s model of paper-based disclosures and shopping. New underwriting models using "Big Data" that

go beyond traditional credit-scoring models raise new opportunities for inclusion of traditionally-excluded populations but also raise new concerns about consumer privacy and the like. Finally, the growing dominance of electronic payments and online shopping raise new concerns about data security and use of consumer data beyond traditional concerns.

In my opinion, the fundamental goal of consumer financial regulation going forward should be to promote greater consumer inclusion among traditionally underserved Americans. The modern consumer financial system works quite well for the typical middle class and upper-middle class family. By and large, most middle-class Americans have easy, ample, and competitive access to most of the financial products they need to make their lives work—bank accounts, mortgages, car loans, credit cards, etc. Although far from perfect (what is?), by and large, middle class people fare well in the modern economy. If they are dissatisfied with a particular provider, they find it relatively easy to switch and find another company.

Sadly, this wide variety of choice in a competitive market free from burdensome government regulation is not the case for many lower-income Americans. Promoting greater financial inclusion will have two elements: first, continuing to clear away legal and regulatory barriers that interfere with this goal today and, second, adopting policies that will promote innovation, competition, and inclusion.

First, and most important, it is imperative to eliminate the many regulatory barriers that currently stand in the way of greater inclusion of underserved populations. Most notably, the Dodd-Frank Financial Reform legislation included a number of provisions that haven proven harmful to lower-income Americans. Most notable, of course, was the so-called "Durbin Amendment" that imposed price controls on debit card interchange fees and other regulatory restrictions on debit card markets. The impact of these mandates has been well-documented: a dramatic decrease in free checking (especially for lower-income consumers) and a dramatic increase in monthly maintenance fees.[29] This whipsaw has led to many lower-income consumers losing access to bank accounts or never acquiring one in the first place. Astonishingly, Congress is now seriously considering extending the Durbin Amendment to credit card routing, which would have a similar detrimental effect with respect to credit card access and pricing.

Also extremely problematic for low-income consumers has been the effects of the Credit CARD Act of 2009, which placed new limits on the ability of credit card issuers to engage in risk-based pricing, which has led to higher costs and reduced access for many consumers, but especially relatively higher-risk borrowers. Provisions that limit the access of college students to credit cards have also disparately impacted lower-income consumers and interfered with their ability to gain access to credit cards. Because credit cards

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[29] *See* Julian Morris, Todd J. Zywicki & Geoffrey A. Manne, *The Effects of Price Controls on Payment-Card Interchange Fees: A Review and Update*, ICLE WHITE PAPER 2022-03-04, at 33 (Mar. 23, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4063914.

are for many people the first step on establishing a credit file, this delay in the ability of lower-income consumers to gain access to credit cards has the follow-on effect of delaying their ability to develop a credit file, which puts them years behind their higher-income peers in establishing a credit record.

Regulators should also investigate more carefully the potential impact of anti-money laundering and other similar regulations on financial inclusion. Anecdotal conversations with industry experts suggest that banks may be deterred from dealing with certain customers, especially immigrants from certain countries, simply to avoid the cost and risk of AML and other regulations. While that may be worth it for wealthier and higher-income accounts, the cost may be disproportionate to the benefits for dealing with lower-income customers.

The entire system of consumer disclosures and how consumers process information must be updated to deal with the realities of the modern technological world. Today, consumers are buried in disclosures that fail to distinguish in any way between what is truly relevant to the consumer in deciding whether to use a product or service and what is not.[30] Moreover, mandated disclosures often require what I have deemed "normative disclosure"—disclosure of information that regulators think consumers *should* care about, rather than what they actually *do* care about—that distracts consumers and leads them to focus on information that is not relevant to their decision.[31]

Except in rare instances, disclosures should be focused on those terms and conditions that are most useful and relevant to consumers when shopping for a product.[32] There is a cost in terms of time and attention for every disclosure a consumer is forced to consider, and other purposes of disclosures should be set aside or provided at a different time of a transaction when actually relevant. Moreover, regulators should also be aware of the limits of disclosure as a device for consumer protection—given the transaction costs associated with both provision of disclosures and its processing by consumers, some modest substantive regulation of terms and conditions (perhaps subject to modification by consumers) may be appropriate in some conditions. The theory is consistent with standard law and economics analysis that suggests tort-type approaches may be appropriate in certain circumstances where transaction costs are high or the costs of one party of avoiding a harm are disproportionately high relative to the other party.

With respect to disclosures, it is also imperative that disclosure requirements be updated to reflect the realities of modern screens and other ways in which consumers access information. For example, rather than starting with a list of everything that a regulator thinks should be disclosed in an ideal world and then mandating it, perhaps regulators should begin with a

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30 *See* OMRI BEN-SHAHAR & CARL E. SCHNEIDER, MORE THAN YOU WANTED TO KNOW: THE FAILURE OF MANDATED DISCLOSURE 7–9 (2014).

31 *See* Todd Zywicki, *The Market for Information and Credit Card Regulation*, 28 BANKING & FIN. SERV. POL'Y REPORT 13, 15 (2009).

32 *See* CFPB TASKFORCE REPORT, *supra* note 3, at ch. 7.

consideration of how much time an average consumer is willing to spend reading and digesting information in disclosures and then require a prioritization of disclosures that will fit within that time.

Bad economics also threatens the future development of the consumer financial system. Junk economic analysis promoted by "Behavioral Economics" is increasingly being pushed to promote new schemes, and to resuscitate old schemes, that effectively amount to little more than the same warmed-over paternalism that proved so disastrous for some any consumers for so many generations. Indeed—astonishingly—proposals to reinstate usury ceilings on credit cards and other types of consumer loans are being discussed once again.[33] I am not aware of any fundamental changes in the law of supply and demand that would suggest that these laws will prove any less harmful to consumers than prior efforts with similar regulations.

Although technological evolution promises great potential for innovation in consumer financial services, it also presents novel threats from both private and public sources. The challenge of protecting one's private financial and personal information from hackers and thieves is profound and will require ongoing innovation to respond to new digital threats.

More important than private threats, however, is the increasingly aggressive and predatory set of government regulators and private financial services providers who increasingly view the financial regulatory tool as a means to accomplish other social and political goals, such as controlling speech or other behaviors, shaping consumption habits, or promoting wealth redistribution. Consider each in turn.

First, the past decade has seen an increasing tendency for government regulators to control speech and other behaviors through the use of the financial system. This practice took hold during the Obama Administration through its nefarious "Operation Choke Point" initiative that targeted legal industries (such a payday loans) as well as providers of constitutionally-protected products such as "racist materials" and firearms and ammunition dealers.[34] Although that initiative was finally rolled up after being attacked through litigation, in recent years it appears that a similar initiative has been underway to "debank" individuals and groups on the basis of their political speech.[35] The use of financial sanctions against the Canadian Truckers to crush their anti-vaccine mandate protests provides a warning as to how financial regulators can use the finance system to crush free speech, freedom

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33 *See* Todd Zywicki, *The Sanders-AOC Protection for Loan Sharks Act*, REAL CLEAR POL'Y (June 2, 2019); https://www.cato.org/commentary/sanders-aoc-protection-loan-sharks-act; *Hawley Introduces New Legislation to Cap Credit Card Interest Rates and Provide Relief to Working Americans*, SEN. JOSH HAWLEY (Sept. 12, 2023), https://www.hawley.senate.gov/hawley-introduces-new-legislation-cap-credit-card-interest-rates-and-provide-relief-working.

34 *See* Norbert Michel, *Newly Unsealed Documents Show Top FDIC Officials Running Operation Choke Point*, FORBES (Nov. 5, 2018), https://www.forbes.com/sites/norbertmichel/2018/11/05/newly-unsealed-documents-show-top-fdic-officials-running-operation-choke-point/?sh=2fa131af1191.

35 *See* Todd Zywicki, *Cancel Culture Comes to Banking*, NEWSWEEK (Jan. 13, 2022).

of association, and other constitutional rights.[36] Congress should act to prohibit this practice to protect individuals, nonprofit groups, and businesses from discrimination based on their political views.[37]

More alarming are proposals for the adoption of a Central Bank Digital Currency, which would present even greater opportunities for government officials to target individuals based on their speech or other activity or to control consumer decisions. Congress should prohibit the Federal Reserve or any other agency from issuing Central Bank Digital Currencies.

Finally, it is evident that left-wing politicians and activist groups increasingly are looking at the consumer financial system as tool for wealth redistribution, especially in pursuit of racial and other "equity" goals. This includes proposals to tinker with the credit reporting system or even to establish a government monopoly credit-reporting system that will enable regulators to eliminate disparities in credit scores among different racial groups.[38]

History has taught fundamental lessons of consumer finance and financial regulation that must be heeded in the future—consumer finance and consumer financial regulation have co-evolved in a spontaneous evolutionary development. Trying to redirect the patterns of consumer finance into directions preferred by regulators, rather than consumers, has proven to be a self-defeating process that ends up harming the most vulnerable consumers and those the laws are ostensibly intended to help. I fear that instead of heeding these lessons, we are again repeating the same mistakes of the past and pretending like somehow this time the results will turn out differently. They won't.

In his Nobel lecture, the great economist Friedrich Hayek provided an admonition to government planners of all stripes, warning them that in trying to shape the evolutionary and economic patterns in a beneficial manner, policy-makers should not try to "shape the results as the craftsman shapes his handiwork" but to "cultivate a growth by providing the appropriate environment, in the manner in which the gardener does this for plants."[39] Hardly a better guide could be provided to those looking to shape the future growth of the consumer financial system in the decades to come.

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36 In one poll, an alarming 65.7% of American Democrats approved of the actions taken by Canadian Prime Minister Justin Trudeau against the protesting truckers while only 17.2% disapproved. *See Nationwide Issues Survey,* THE TRAFALGAR GROUP, (Feb. 2022), https://www.thetrafalgargroup.org/wp-content/uploads/2022/02/COSA-Trudeau-Truckers-Poll-Report-0221.pdf.

37 *See* DEP'T OF THE TREASURY, OFF. OF THE COMPTROLLER OF THE CURRENCY, FAIR ACCESS TO FIN. SERVS., 12 CFR Part 55 (Jan. 14, 2021), https://www.occ.gov/news-issuances/news-releases/2021/nr-occ-2021-8a.pdf.

38 *See, e.g.*, Todd Zywicki, *A Government Credit-Rating Monopoly?* 45 REGUL. 22 (Spring 2022).

39 Hayek, *supra* note 2, at 7.

FINANCE WITHOUT GOVERNMENT: FINANCIAL REGULATION IN AN AGE OF POLITICAL UNREST

*Jonathan Macey**

INTRODUCTION

This Article explores the U.S. financial system from the perspective of the turmoil and dysfunction that currently characterizes the U.S. political and economic landscape. Here, I observe that there is an important, surprising, and unexamined gulf between the robust strength of U.S. capital and financial markets and the deteriorating condition of the U.S. political system. Notwithstanding a strong consensus among political scientists and economists that political instability is "a serious malaise harmful to economic performance,"[1] the U.S. financial system appears to be largely immune from the damage that one might expect to result from the recent political instability in the U.S.

From the perspective of considering the future of financial regulation in the U.S., the basic insight is that structural components of the U.S. regulatory system, particularly the independent central bank, the provision of corporate law and corporate governance rules at the state rather than the federal level, the independent judiciary and its protection of free speech have worked well to insulate the capital markets from the recent political turmoil. While the growth of regulation of financial markets likely will continue unabated, such regulation is and will continue to be, largely irrelevant in a macro sense. The analysis here is consistent with previous work in which I have posited that markets have responded to governmental failings by crafting a libertarian path forward that does not rely on regulators, Congress, or the executive to provide solutions to problems.[2]

There seems to be little doubt that government dysfunction should affect fundamental financial and economic issues like corporate governance and capital markets regulation. Increasingly, political science professors and corporate governance experts have pointed to "interference with electoral processes, disruptions to orderly transitions of power, deterioration of checks and balances across branches of government, and/or the erosion of the rule

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[1] Ari Aisen & Francisco Jose Veiga, *How Does Political Instability Affect Economic Growth?*, 3 (International Monetary Fund Working Paper No. 11/12, 2011).

[2] Jonathan Macey, *ESG Investing: Why Here? Why Now?,* 19 BERKELEY BUS. L. J. 258 (2022).

of law"[3] and argued that these threats to democracy "pose financial and economic risks for investors."[4] These concerns are hardly surprising because it is widely accepted that political risk, which is the risk that government activities, faulty governors, and a poor legal and institutional environment will negatively affect the profitability of businesses and the value of financial assets in an economy,[5] is a topic of acute concern to international managers.[6]

The problem this Article confronts is that the theory does not hold true. The massive political dysfunction in the U.S. appears to have virtually no discernible effect on capital markets or financial stability. Surprisingly, capital markets appear to have insulated themselves from political turmoil. As discussed below, even when the well-regarded credit rating agency Fitch lowered the long-term rating of U.S. government debt to AA+ from its previous top grade of AAA, largely due to "governance problems," the move was "widely dismissed as meaningless."[7] For better or worse, it appears that private sector capital markets have untethered themselves from politics and government.

POLITICAL TURMOIL

A recent White Paper by the United States Democracy Center and the Brookings Institution flatly asserts that "[t]hreats to democracy in the United States pose a risk to investors and the economy."[8] Layna Mosley, a Princeton professor of Politics and International Affairs, believes that the threat to capital markets from threats to democracy from election deniers and insurrectionists is so significant that "[i]nstitutional investors have a fiduciary duty to not only monitor but also respond to threats to democratic institutions in the U.S., just as they would do for other countries. These threats include the

3 *New Survey: Institutional Investors Believe American Democracy Is Increasingly at Risk*, STATES UNITED DEMOCRACY CTR., (Aug. 23, 2023), https://statesuniteddemocracy.org/resources/new-survey-institutional-investors/.

4 *Threats to Democracy in the U.S. Pose Financial and Economic Risks for Investors*, STATES UNITED DEMOCRACY CTR., (July 11, 2023), https://statesuniteddemocracy.org/new-report-threats-to-democracy-in-the-u-s-pose-financial-and-economic-risks-for-investors/.

5 Geert Bekaert et al., *Political Risk Spreads*, 45 J. INT. BUS. STUD. 471 (2014); Stephen Davis, *Financial Implications of Rising Political Risk in the U.S.*, HARV. L. SCH. F. ON CORP. GOVERNANCE, (Sept. 15, 2023), https://corpgov.law.harvard.edu/2023/09/15/financial-implications-of-rising-political-risk-in-the-us/; Adel Al Khattab et al., *Managerial Perceptions of Political Risk in International Projects*, 25 INT'L J. PROJECT MGMT. 734 (2007); Ephraim Clark, *Valuing Political Risk*, 16 J. INT'L MONEY & FINANCE 477 (1997).

6 Mehdi Janbaz et al., *Political Risk in Banks: A Review and Agenda*, 62, RSCH. IN INT'L BUS. AND FIN. (2022) (political risk is "a critical factor in the corporate sector").

7 Greg Ip, *Why Fitch's Downgrade Matters*, WALL ST. J., (Aug. 9, 2003), https://www.wsj.com/articles/fitch-downgrade-us-credit-rating-4ad98230.

8 STATES UNITED DEMOCRACY CTR., *supra* note 3.

risks that election deniers pose."[9] Alarmingly, "thirty-three percent of election-denying candidates (15 out of 46 in the general election) prevailed in their statewide races" for governor, attorney general and secretary of state, and eight election deniers who were not up for re-election in 2022 remain in office.[10] Looking at candidates for the House of Representatives and Senate, along with state legislative candidates, 226 election deniers, or about 66 percent of those running for office, prevailed in their election contests.[11] Election deniers have important positions in many state legislatures, and many members of the Republican party majority in the U.S. House of Representatives are election deniers.[12] This provides strong evidence that "the erosion of democratic practices and norms remains a serious threat in the United States."[13]

The general consensus is that political instability should be a source of deep concern to the financial markets. As one commentator observed: "If global investors suddenly develop suspicions about the U.S. political system, that it's not stable, they will stop buying our debt. So, U.S. interest rates will go up. Mortgage rates will go up. . . . When interest rates go up, it's not good for the stock market. So people's 401(k)s will go down. . . . There are a lot of really ugly scenarios that could unfold."[14]

The highly plausible notion that threats to democracy are a problem for the financial system received substantial support on August 1, 2023, when Fitch Ratings downgraded the United States' Long-Term Foreign Currency Issuer Default Rating (IDR) to AA+ from AAA.[15] In explaining its rating downgrade, Fitch observed: "The rating downgrade of the United States reflects the expected fiscal deterioration over the next three years, a high and growing general government debt burden, and the erosion of governance relative to 'AA' and 'AAA' rated peers over the last two decades that has manifested in repeated debt limit standoffs and last-minute resolutions."[16]

Fitch specifically identified "erosion of governance" among the factors influencing the Company's decision to downgrade U.S. debt; in fact:

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9 Layna Mosley, *The Financial and Economic Dangers of Democratic Backsliding*, 3 STATES UNITED DEMOCRACY CTR. (July 2023), https://statesuniteddemocracy.org/wp-content/uploads/2023/07/THE-FINANCIAL.pdf.

10 *Id.* at 1.

11 *Id.*

12 *Id.*

13 *Id.*

14 David Lynch, *Stocks Drive Higher, Brushing Aside Worries About U.S. Stability: Capital Violence and the Threat of More to Come, Don't Faze Investors*, WASH. POST (Jan. 14, 2021), https://www.washingtonpost.com/business/2021/01/14/stocks-capitol-riot/.

15 *Fitch Downgrades the United States' Long-Term Ratings to 'AA+' from 'AAA'; Outlook Stable, Rating Action Commentary*, FITCH RATINGS (Aug. 1, 2023), https://www.fitchratings.com/research/sovereigns/fitch-downgrades-united-states-long-term-ratings-to-aa-from-aaa-outlook-stable-01-08-2023.

16 *Id.*

> In Fitch's view, there has been a steady deterioration in standards of governance over the last 20 years, including on fiscal and debt matters, notwithstanding the June bipartisan agreement to suspend the debt limit until January 2025. The repeated debt-limit political standoffs and last-minute resolutions have eroded confidence in fiscal management. In addition, the government lacks a medium-term fiscal framework, unlike most peers, and has a complex budgeting process. These factors, along with several economic shocks as well as tax cuts and new spending initiatives, have contributed to successive debt increases over the last decade. Additionally, there has been only limited progress in tackling medium-term challenges related to rising social security and Medicare costs due to an aging population.[17]

The timing of the Fitch downgrade, which some observers described as "strange,"[18] indicates that the downgrade likely was attributable to the deteriorating political landscape in the U.S. rather than to economic factors. The downgrade was characterized as strange because it came at a time when "the United States was actually improving on all the metrics that Fitch set out in its ratings watch last year. The national debt has fallen relative to the gross domestic product (GDP). The U.S. economy has avoided a recession even as inflation rates have come down. President Joe Biden and Speaker of the House Kevin McCarthy reached an agreement to suspend the debt ceiling in June [2023]."[19] At the time of the downgrade, the S&P 500 was up 18 percent on the year and had not had a down day of 1 percent or more in 47 straight sessions, the longest streak of "calm days" since January 2020.[20]

There is ample support for the proposition that the political turmoil in the United States is a problem for capital markets. Harvard Business School Professor Rebecca Henderson described what she characterized as "the decline of democracy" as a "mortal threat to the legitimacy and health of capitalism."[21] She argues, "American business needs American democracy. Free markets cannot survive without the support of the kind of capable, accountable government that can set the rules of the game that keep markets genuinely free and fair. And only democracy can ensure that governments are held accountable, that they are viewed as legitimate, and that they don't devolve into the rule of the many by the few and the kind of crony capitalism that we see emerging in so many parts of the world."[22]

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[17] *Id.*

[18] Brad W. Setser, *Does Fitch's Downgrade of U.S. Debt Really Matter?*, COUNCIL ON FOREIGN RELS. (Aug. 16, 2023), https://www.cfr.org/article/does-fitchs-downgrade-us-debt-really-matter.

[19] *Id.*

[20] Sagarika Jaisinghani & Julien Ponthus, *What Analysts Say About US Credit Downgrade by Fitch*, BLOOMBERG (Aug. 1, 2023), https://www.bloomberg.com/news/articles/2023-08-02/dollar-s-drop-on-fitch-downgrade-unlikely-to-persist-analysts.

[21] Rebecca M. Henderson, *Building a Strong Democracy: Q&A with Professor Rebecca Henderson,* HARV. BUS. SCH. (Sept. 1, 2020), https://www.alumni.hbs.edu/stories/Pages/story-bulletin.aspx?num=7625.

[22] Rebecca Henderson, *Business Can't Take Democracy for Granted*, HARV. BUS. REV. (Jan. 8, 2021), https://hbr.org/2021/01/business-cant-take-democracy-for-granted.

The problem appears to be more serious even than concerns about the orderly transition of power in the executive branch and the January 6, 2021, insurrection. Henderson reports survey data showing that fifty-five percent of Americans say that their democracy is "weak," with 8% claiming that it is growing weaker. Approximately one-half of respondents agreed with the statement that America is in "real danger of becoming a nondemocratic, authoritarian country." Perhaps worst of all, 70% of Americans expressed the view that "[o]ur political system seems to only be working for the insiders with money and power, and two-thirds of Americans aged 18-29 have "more fear than hope about the future of democracy in America."[23]

In 2021, the Stockholm-based International Institute for Democracy and Electoral Assistance added the United States to its list of "backsliding democracies," observing that "significantly, the United States, the bastion of global democracy, fell victim to authoritarian tendencies itself and was knocked down a significant number of steps on the democratic scale."[24] The Report observed: "A historic turning point came in 2020–2021 when former President Donald Trump questioned the legitimacy of the 2020 election results in the United States. Baseless allegations of electoral fraud and related disinformation undermined fundamental trust in the electoral process, which culminated in the storming of the US Capitol building in January 2021."[25]

Significantly, from the perspective of evaluating the effects of the events of 2020-2021 on the stability of U.S. democracy, the Institute observed that arguments similar, and equally baseless, to the ones Trump made to undermine the election, were used to justify a political coup in newly democratic Myanmar in February 2021, and to challenge election results in Peru, Mexico, and Brazil.[26] As the Washington Post observed:

> Former president Donald Trump's effort to undermine the legitimacy of the 2020 presidential election, a campaign that culminated in the Jan. 6 insurrection at the U.S. Capitol one year ago, looms large in these assessments. Many — including top military officers — feared a coup on U.S. soil. Some experts consider the insurrection itself to have been an attempted coup. Since then, some Trump allies, including former national security adviser Michael Flynn, have openly embraced the idea of a military takeover, and high-

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23 Rebecca Henderson, *The Business Case for Saving Democracy*, HARV. BUS. REV. (Mar. 10, 2020), https://hbr.org/2020/03/the-business-case-for-saving-democracy.

24 International Institute for Democracy and Electoral Assistance, THE GLOBAL STATE OF DEMOCRACY 2021 iii (2021), https://www.idea.int/democracytracker/sites/default/files/2022-11/GSOD21.pdf [hereinafter IIDEA].

25 *Id.* at 15; *see also* Press Release, Org. for Security and Co-Operation in Europe, Highly Competitive Elections in US Tarnished by Legal Uncertainty and Unprecedented Attempts to Undermine Public Trust, International Observers Say (Nov. 4, 2020), https://www.osce.org/odihr/elections/usa/469440 (on file with the OSCE Office for Democratic Institutions and Human Rights, Washington D.C.).

26 IIDEA, *supra* note 24, at 5.

> profile political observers now argue that U.S. democracy is deep into a constitutional crisis and that the "next coup has already begun."[27]

Professional investors appear to share these concerns about the future of democracy, particularly when those threats concern countries outside of the United States. A stunning 90 percent of large institutional investors surveyed by the United States Democracy Center and the Brookings Institution believe "threats to American democracy are rising."[28] While concerns about political risk appear to be growing, institutional investors remain more concerned with political risk outside of the U.S. than inside the U.S.[29] Corporate governance commentator Stephen Davis has described the survey results showing concern for political risk outside of the U.S. but not inside the U.S. as revealing "striking anomalies."[30]

In principle, the link between political stability and capital market stability seems clear and obvious. The problem might appear to be particularly acute in the U.S. because President Donald Trump, the foremost instigator of the current rise in political instability, has expressed a strong willingness to sacrifice economic stability for his own political purposes. This became clear in mid-September 2023 when Trump urged members of the Republican party in Congress to shut down the government in order to starve the federal prosecutors investigating his fraud and election interference of funds necessary to continue their work.[31] Trump asserted on his Truth Social media site that "Republicans in Congress can and must defund all aspects of Crooked Joe Biden's weaponized Government," calling it "the last chance to defund these political prosecutions against me and other Patriots."[32]

What seems most remarkable, however, is how little impact recent political turmoil and governmental dysfunction has had on U.S. capital markets and the U.S. economy. Even Fitch's downgrade of U.S. government debt

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27 Noam Lupu, Luke Plutowski & Elizabeth Zechmeister, *Would Americans Ever Support a Coup? 40 Percent Now Say Yes*, WASH. POST, (Jan. 6, 2022), https://www.washingtonpost.com/politics/2022/01/06/us-coup-republican-support/.

28 STATES UNITED DEMOCRACY CTR., *supra* note 3.

29 *Id.*

30 Stephen Davis, *Financial Implications of Rising Political Risk in the US*, HARV. L. SCH. F. ON CORP. GOVERNANCE, (Sept. 15, 2023), https://corpgov.law.harvard.edu/2023/09/15/financial-implications-of-rising-political-risk-in-the-us.

31 Susan Heavey & Doina Chiacu, *Trump Urges Government Shutdown in Unlikely Bid to 'Defund' His Criminal Prosecutions*, REUTERS (Sept. 21, 2023), https://www.reuters.com/world/us/trump-urges-government-shutdown-unlikely-bid-defund-his-criminal-prosecutions-2023-09-21/; Sarah Fortinsky, *Trump: Funding Deadline 'Last Chance' To Defund 'Political Prosecutions Against Me,'* THE HILL (Sept. 21, 2023), https://thehill.com/homenews/house/4215839-trump-funding-deadline-last-chance-to-defund-political-prosecutions-against-me-strong.

32 Fortinsky, *supra* note 31.

"was met with what amounts to a shrug" by capital markets participants.[33] Market participants at banks and hedge funds described any negative impact as "short and shallow"[34] and they characterized the event as a "tempest in a teapot."[35]

The basic point here is that Donald Trump's efforts to nullify the results of the 2020 presidential election—including the January 6 attack on the Capitol, the personal calls and threats to state officials such as Georgia Secretary of State, Brad Raffensperger, and the attempts to create and submit fraudulent certificates of ascertainment submitted by "fake electors" who would falsely claim that Trump had won the Electoral College vote—have had surprisingly little effect on capital markets. In this context, a study by John Stephens, Seyed Mehdian, Stefan Ghergina, and Ovidu Stoica of the reaction of the financial markets to the January 6 Capitol attack is particularly relevant.[36]

In this study, the authors characterize the January 6 attack as "an unexpected political event,"[37] and uses event study methodology to study the aggregate reactions, on a minute-by-minute basis of the U.S. stock markets and the more international cryptocurrency markets, as reflected in the Dow Jones Industrial Average index, the Nasdaq 100 index, the S&P 500 index and the price of Bitcoin, the most prominent cryptocurrency during the period 9:00 a.m. to 4:00 p.m. on January 6.[38] The authors found that immediately after the attack on the Capitol, "the value of Bitcoin and the indices took a slightly declining turn."[39] This decline, however, was not statistically significant, which indicates that "while the January 6 attack on the U.S. Capitol may have political importance . . . it lacks substantial financial implications."[40] Consistent with this analysis, stock watchers observed that stock markets "seem impervious to . . . the erosion of American democracy" illustrated by the "shocking events [of January 6] when an American president incited a mob to confront lawmakers preparing to certify his electoral defeat.[41] In fact, the Dow Jones Industrial Average, which had risen by sixty-seven percent since the pandemic, rose to 31,000 on January 7, the day after the Capitol riot.[42] In fact, all three leading indices, which includes the S&P 500 as well as the

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33 Sagarika Jaisinghani & Julien Ponthus, *What Analysts Say About US Credit Downgrade by Fitch*, BLOOMBERG (Aug. 1, 2023), https://www.bloomberg.com/news/articles/2023-08-02/dollar-s-drop-on-fitch-downgrade-unlikely-to-persist-analysts.

34 *Id.*

35 *Id.*

36 John Stephens, et al., *The Reaction of the Financial Market to the January 6 United States Capitol Attack: An Intraday Study*, 56 FIN. RSCH. LETTERS 104048 (2023).

37 *Id.*

38 *Id.*

39 *Id.*

40 *Id.*

41 David Lynch, *Stocks Drive Higher, Brushing Aside Worries About U.S. Stability*, WASH. POST (Jan. 14, 2021, 6:00 AM), https://www.washingtonpost.com/business/2021/01/14/stocks-capitol-riot/.

42 *Id.*

Nasdaq Stock Market, rose as the riot was unfolding,[43] leading to headlines like "Wall Street's reaction to Washington mayhem? All-time highs."[44]

Observing the volatility of financial markets during the January 6 insurrection is another way of gaining insight into the economic effects of recent political turmoil. Previous research has found that political unpredictability leads to higher volatility in stock prices.[45] A standard measure of stock market volatility is the CBOE Volatility Index, known as the VIX, which measures the implied volatility of the S&P 500. Implied volatility is a forward-looking metric used by options traders that measures future volatility as reflected in options premiums through the use of the Black-Scholes options pricing model. The VIX is often referred to as the market's "fear gauge," and is "used by investors to measure market risk, fear and stress."[46] In general, VIX values of greater than thirty are considered to signal heightened volatility from increased uncertainty, risk and investor fear. VIX values below twenty generally correspond to more stable, less stressful periods in the markets.[47] As shown in the table below,[48] stock market volatility was in line with previous days and not abnormal. Moreover, market volatility has declined since the attack, falling below twenty at the end of March 2023 and remaining so until the time of this writing, September 22, 2023, when the VIX at the close was 17.20.[49]

Stock Market Volatility Around the January 6, 2021, Attack on the Capitol				
Date	VIX (open)	VIX (high)	VIX (low)	VIX (close)
December 31, 2020	22.99	23.25	21.24	22.75
January 4, 2021	23.04	29.19	22.56	26.97
January 5, 2021	26.94	28.60	24.80	25.34

43 Stephen Gandel, *Wall Street's Reaction to Washington Mayhem? All-time Highs*, CBS NEWS (Jan. 7, 2021, 6:21 PM), https://www.cbsnews.com/news/stock-market-united-states-capitol-breach-january-7/.

44 *Id.*

45 John W. Goodell & Sami Vähämaa, *US Presidential Elections and Implied Volatility: The Role of Political Uncertainty*, 37 J. BANK FIN. 1108 (2013).

46 *VIX: What You Should Know About the Volatility Index*, FIDELITY INT'L, https://www.fidelity.com.sg/beginners/what-is-volatility/volatility-index (last visited Mar. 28, 2024).

47 *Id.*

48 *CBOE Volatility Index (VOX)*, YAHOO FIN., https://finance.yahoo.com/quote/%5EVIX/history?period1=1609372800&period2=1610409600&interval=1d&filter=history&frequency=1d&includeAdjustedClose=true (last visited Mar. 28, 2024).

49 *Id.*

January 6, 2021	25.48	26.77	22.14	25.07
January 7, 2021	23.67	23.91	22.25	22.37
January 8, 2021	22.43	23.34	21.42	21.56
January 11, 2021	23.31	24.81	23.23	24.08
January 12, 2021	23.49	25.15	22.83	23.33

Another measure of the continued vibrancy of U.S. financial markets in the face of political turmoil is the continued ability of companies to raise capital in the public equity markets through initial public offerings ("IPOs") of their securities. This measure seems particularly relevant because the ability of firms to obtain external financing in the capital markets appears to depend critically on the quality of the legal environment in the market in which the securities are issued.[50] The number of initial public offerings rose from 232 in 2019 to 480 in 2020, and then to a remarkable 1,035 in 2021.[51]

Another measure of the response of U.S. financial markets to the recent political turmoil and threats to democracy poised by election deniers is foreign direct investment into the United States. If the January 6 riots and the efforts to overturn the U.S. election were undermining confidence in the U.S. as a place to do business, then one might expect foreign direct investment into the United States to have declined during 2021, the year in which the riots occurred. Foreign direct investment is a category of cross-border investment in which an investor resident in one economy "establishes a lasting interest in and a significant degree of influence over an enterprise resident in another economy. Ownership of ten percent or more of the voting power in an enterprise in one economy by an investor in another economy is evidence

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50 Rafael La Porta, et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131, 1149 (1997).

51 *Number of IPOs in the United States from 1999 to 2022*, STATISTA, https://www.statista.com/statistics/270290/number-of-ipos-in-the-us-since-1999 (last visited Mar. 28, 2024). A more conservative tabulation of IPOs has been prepared by Jay Ritter. His statistics exclude ADRs, natural resource limited partnerships and trusts, closed-end funds, REITs, SPACs, banks and S&Ls, unit offers, penny stocks (offer price of less than $5 per share), and stocks not listed on Nasdaq or the NYSE (including NYSE MKT LLC, the former American Stock Exchange). This tabulation shows IPOs strong during the relevant period, with IPOs increasing to 165 in 2020 from 113 in 2019. IPOs in 2021 increased to 311 from the 2020 estimate of 165. Jay Ritter, *Initial Public Offerings: Updated Statistics*, UNIV. OF FL. WARRINGTON COLL. OF BUS. (Sept. 20, 2023), https://site.warrington.ufl.edu/ritter/ipo-data/. Yet another tabulation, this one by the accounting firm EY, listed 168 IPOs in 2019, 224 in 2020, and 416 in 2021. Rachel Gerring & Mark Schwartz, *IPO Activity Still Slow in 1H 2023, But Market Conditions Are Improving*, EY (July 25, 2023), https://www.ey.com/en_us/ipo/1h-2023-ipo-market-trends.

of such a relationship."[52] It is well known, of course, that foreign direct investment contributes positively to the Gross Domestic Product ("GDP") of the host countries by bringing in foreign exchange reserves and improvement of the Balance of Payment for the economies that receive such foreign direct investment.[53]

Not surprisingly, political risk is strongly negatively correlated with foreign direct investment, even in high income countries.[54] Political uncertainty is thought to be a major determining factor of long-term economic growth, and political uncertainty is associated with decreases in GDP growth, employment, and investment and adverse effects to equity prices.[55]

Thus, it appears that the genuinely disturbing events in the United States in the wake of the 2020 election had surprisingly little effect on the capital markets. This result is surprising because it seems to run counter to the long-held hypothesis in development economics that uncertain socio-political conditions affect growth negatively.[56] Remarkably, and clearly counter to the notion that the political turmoil surrounding the 2020 election was a signal of political instability, new U.S. foreign direct investment for 2021 was $362.6 billion, a 140% increase from 2020,[57] and significantly above the annual average of $298.8 billion during the period 2014 to 2021.[58] Foreign direct investment as a percentage of GDP rose from 0.71%. in 2021 to 1.52% in 2022, the highest level since 2017.[59] In fact, the United States recorded the largest increase in foreign direct investment of all economies in 2021, with an increase of 11.3%.[60]

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52 *Foreign Direct Investment (FDI)*, ORG. FOR ECON. COOP. & DEV., https://doi.org/10.1787/9a523b18-en (last visited Mar. 28, 2024); *see also* Maitena Duce, *Definitions of Foreign Direct Investment (FDI): A Methodological Note*, BANK FOR INT'L SETTLEMENTS, July 31, 2003, at 2–3.

53 E. Borensztein et al., *How Does Foreign Direct Investment Affect Economic Growth?*, 45 J. INT'L ECON. 115 (1998).

54 Mashrur Mustaque Khan & Mashfique Ibne Akbar, *The Impact of Political Risk on Foreign Direct Investment*, 5 INT'L J. ECON. & FIN. 147, 151–52 (2013).

55 Wonseok Choi, et al., *Firm-level Political Risk and Corporate Investment*, 46 FIN. RSCH. LETTERS 102307 (2022).

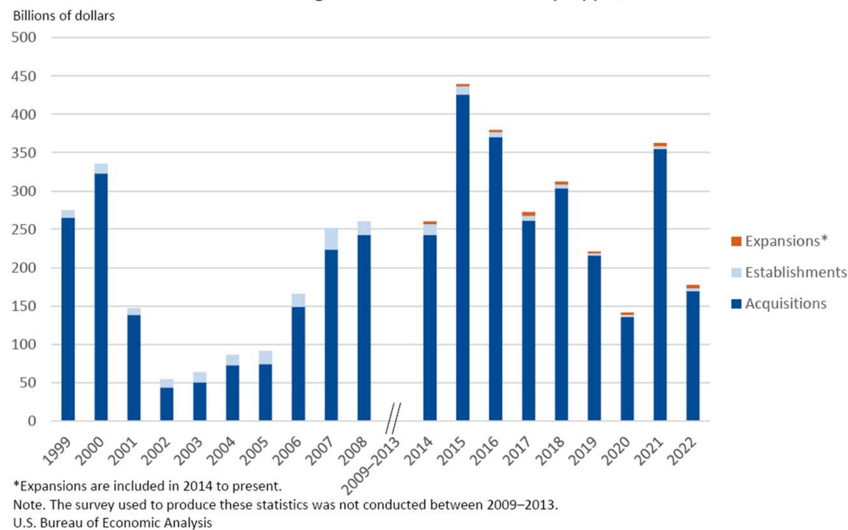
56 Robert Barro, *Economic Growth in a Cross-Section of Countries*, 106 QUARTERLY J. ECON. 407, 432 (1991); Alberto Alesina & Roberto Perotti, *Income Distribution, Political Instability and Investment*, 40 EUR. ECON. REV. 1203 (1996); Dimitrios Asteriou & Costas Siriopoulos, *The Role of Political Instability in Stock Market Development and Economic Growth: The Case of Greece*, 29 ECON. NOTES BY BANCA MONTE DEI PASCHI DI SIENA SPA 355, 356 (2000).

57 *New Foreign Direct Investment in the U.S., 2022*, BUREAU OF ECON. AFF., July 10, 2023. The survey used to produce the statistics was not conducted between 2009 and 2013.

58 *Id.*

59 *United States Foreign Direct Investment, Net Inflows (% Of GDP)*, TRADING ECON., https://tradingeconomics.com/united-states/foreign-direct-investment-net-inflows-percent-of-gdp-wb-data.html (last visited Mar. 28, 2024).

60 Jannick Damgaard & Carlos Sánchez-Muñoz, *United States Is World's Top Destination for Foreign Direct Investment*, INT'L MONETARY FUND BLOG (Dec. 7, 2022), https://www.imf.org/en/Blogs/Articles/2022/12/07/united-states-is-worlds-top-destination-for-foreign-direct-investment.



CONSTITUTIONAL STRUCTURE AND DESIGN

The most likely explanation for why the recent political instability has had so little effect on capital markets is the presence of three critical structural features of the U.S. political system: the independent federal judiciary, the independent Federal Reserve, and the continuing power of the state over fundamental rules of corporate law and corporate governance. These key components of economic regulation operate at a relatively safe distance from the partisan politics of Congress and the executive and have been largely (though not entirely) unaffected by Trumpian threats to democracy.

It is well understood that well-designed institutions can improve economic performance,[61] and the continued smooth functioning of U.S. capital markets in the wake of Trump-era political turmoil provides strong additional support for this basic proposition.

THE FEDERAL JUDICIARY

It is well-known that the U.S. judicial system responded relatively well to the recent political upheaval and anti-democratic initiatives. As William Galston and Elaine Kamarack have observed:

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[61] Jan Elster, *The Impact of Constitutions on Economic Performance*, 8 WORLD BANK ECON. REV. 209 (1994).

> under assault from then-President Trump, the judiciary remained independent despite his repeated attempts to win in the courts what he could not win at the ballot box. President Trump-appointed judges often made decisions that thwarted Mr. Trump's attempts to overturn the results. In fact, after the election Mr. Trump's team and allies brought 62 lawsuits and won exactly one. (The others he either dropped or lost.) Many of those decisions were handed down by Republican judges. Perhaps former President Trump's biggest disappointment was the Supreme Court's decision not to hear election challenges concerning states he claimed he had won.[62]

Interestingly, it appears that, while Trump and his co-defendants fared slightly better at the state and local level than they did at the federal level, they still only persuaded eighteen percent of the total number of judges in their cases at the state and local level.[63]

In addition to denying spurious attempts to overturn legitimate election results, the independent federal judiciary protects democracy, and in so doing, provides the political stability required to maintain well-functioning capital markets. Protection of the right to freedom of speech guaranteed in the First Amendment, which the courts faithfully protect, is a related factor in mitigating the negative economic effects of Trump's anti-democratic machinations.[64]

Freedom of speech is critical to the operation of capital markets because it protects (perhaps too well) those who criticize government policies, including government policies that undermine capital markets. As Harry Kalven argued, the freedom of speech guaranteed by the First Amendment is tantamount to a protection of autonomy.[65] Or, as Owen Fiss maintained, the purpose of free speech is not "individual self-actualization, but rather the preservation of democracy and the right of a people to decide what kind of life it wishes to live."[66] Amartya Sen famously observed that no substantial famine has ever occurred in a country with a free press.[67] Sen observed that the

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62 William A. Galston & Elaine Kamarack, *Is Democracy Failing and Putting Our Economic System at Risk?*, BROOKINGS (Jan. 4, 2022), https://www.brookings.edu/articles/is-democracy-failing-and-putting-our-economic-system-at-risk; *see also* William Cummings, et al., *By the Numbers: President Donald Trump's Failed Efforts to Overturn the Election*, USA TODAY (Jan. 6, 2021, 5:01 AM), https://www.usatoday.com/in-depth/news/politics/elections/2021/01/06/trumps-failed-efforts-overturn-election-numbers/4130307001; Alanna Durkin Richer, *Trump Loves to Win But Keeps Losing Election Lawsuits*, ASSOCIATED PRESS (Dec. 4, 2020, 8:04 PM), https://apnews.com/article/donald-trump-losing-election-lawsuits-36d113484ac0946fa5f0614deb7de15e.

63 Russell Wheeler, *Trump's Judicial Campaign to Upend the 2020 Election: A Failure, But Not a Wipe-out*, BROOKINGS (Nov. 30, 2021), https://www.brookings.edu/blog/fixgov/2021/11/30/trumps-judicial-campaign-to-upend-the-2020-election-a-failure-but-not-a-wipe-out/.

64 Owen Fiss, *Free Speech and Social Structure*, 71 IOWA L. REV. 1405, 1405 (1986) (the Supreme Court has nurtured the principle of freedom of speech and "given it much of its present shape, and accounts for much of its energy and sweep").

65 *See generally* Harry Kalven, *The New York Times Case: A Note on "The Central Meaning of the First Amendment"*, 1964 SUP. CT. REV. 191 (1964).

66 Fiss, *supra* note 64, at 1409–10.

67 Frances D'Souza, *Democracy as a Cure for Famine*, 31 J. PEACE RSCH. 369, 369 (1994) (*citing* Amartya Sen, *Liberty and Poverty: Political Rights and Economics*, 210 THE NEW REPUBLIC 31, 31–37 (1994)).

information disseminated by a free press creates strong incentives for politicians to address problems that are likely to galvanize voters to demand change. In addition, the information generated by a free press provides information to the highest levels of government that lower level officials may hide from them for fear of challenging the prevailing popular myths favored by incumbent politicians at the top. Frances D'Souza illustrates the power of freedom of the press in avoiding economic disaster with a story about the famine of 1959-1961 in China:

> The famine of 1959-61 was a direct result of the withholding of information at all levels of Chinese bureaucracy. Moreover, the active censorship and disinformation prevented effective famine relief once the disaster had begun, and certainly prolonged the effects by concealing the gravity of the problem. It was not so much people in the cities and larger towns who suffered but the rural poor who were decimated, village by village. And yet, at the height of the famine, peasants did not dare even speak about the deaths of family members for fear of challenging the prevailing myth of economic miracle and food abundance. It cannot be known whether the leaders actually believed assurances that agricultural production was about to surpass that of the previous bumper year: what was important was that the myth was perpetrated and sustained through fear and censorship. This served as a wholly effective barrier to accurate information and therefore to any relief action. The complex and rigid levels of bureaucracy, governed by Mao Zedong at the pinnacle and ruled by corruption and terror, encouraged the cadres at the commune and county level to exaggerate agricultural production because they were asked to do so by the level of bureaucracy above them, the district cadres and so on, right up to the top. Peasants at the communal level were obliged to wildly exaggerate the harvest estimate through fear of punishment; these wild estimates were further exaggerated at each level of bureaucracy, yielding a grossly distorted figure which precluded any accurate information or knowledge about the dearth of grain at the rural level.[68]

It is well known that President Trump regularly attacked the free speech throughout his presidency.[69] During Trump's first 100 days in office, the writer's free speech advocacy organization PEN America catalogued 70 separate instances of attacks on the press by Trump or senior Administration officials, including describing the press as "the enemy of the people."[70] As PEN America observed, there were "near-daily efforts by the Trump Administration to undermine the press during the President's first 100 days. Such efforts not only chip away at public trust for the media and its indispensable role in keeping the public informed, but also signal to regimes abroad that the United States will not stand up for press freedom."[71] No court, however, showed any proclivity for limiting First Amendment speech protections.

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68 *Id.* at 371.

69 James Tager, *Trump the Truth: Free Expression in the President's First 100 Days*, PEN AM. (Apr. 27, 2017), https://pen.org/research-resources/trump-the-truth/.

70 *Id.*

71 *Id.*

THE FEDERAL RESERVE

The political turmoil that led to the downgrade of the U.S. credit rating did not have a significant effect on U.S. capital markets because the downgrade was not viewed as changing the Fed policy in general and Fed policy towards interest rates in particular.[72] The Fed's policy on interest rates was expected to "continue to be guided by incoming economic data such as non-farm payrolls (NFP) . . . and the Consumer Price Index"[73] as a measure of inflation.

Over the past 50 years or so, a clear consensus has emerged that granting central banks independence so that they can conduct monetary policy free from political pressure from elected officials produces positive economic outcomes because the independence allows them to resist pressure to exploit short-term trade-offs between inflation and employment.[74]

During Donald Trump's term as President, he continually attempted to undermine the independence of the Fed. He has been characterized as being "voracious in his frequent attacks on Fed policy."[75] Trump was particularly aggressive in his criticism of Federal Reserve Chair, Jerome Powell, whom he described as a "golfer who can't putt," and as a "bigger enemy" to the United States than Chinese President, Xi Jinping.[76]

As officials of the European Central Bank observed in a paper on central bank independence, while in office President Trump:

> repeatedly threatened to remove the Fed's Chair and voiced his intention to appoint close political allies and outspoken critics of the Fed to two seats of the central bank's Board. In addition, the President has publically and repeatedly called for lower interest rates and faster rate cuts in order to boost the economy and as a policy response to shocks arising

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72 *Fitch's Downgrade of the US – Interesting Timing with Muted Reaction*, FRANKLIN TEMPLETON (Aug. 2, 2023), https://www.franklintempletonme.com/articles/2023/western-asset/fitchs-downgrade-of-the-us-interesting-timing-with-muted-market-reaction.

73 *Id.*

74 Marc Labonte & Gail E. Makinen, *Central Bank Independence and Economic Performance: What Does the Evidence Show?*, CONG. RSCH. SERV. (June 6, 2007), https://crsreports.congress.gov/product/pdf/RL/RL31955/6; Tobias Adrian, *Central Bank Independence and the Development of Payments and CBDCs*, INT'L MONETARY FUND (Jan. 10, 2023), https://www.imf.org/en/News/Articles/2023/01/10/sp-central-bank-independence-development-payments-and-cbdc, ("To date, numerous studies have validated the critical importance of *independence* for monetary policies that are aimed at low and stable inflation.").

75 Thilo Kind et al., *Threatening Central Bank Independence One Tweet at a Time*, CTR. FOR ECON. POL'Y RSCH. (Jan. 25, 2020), https://cepr.org/voxeu/columns/threatening-central-bank-independence-one-tweet-time.

76 Matt Egan, *Trump's Attacks on the Fed are Moving Markets, Study Shows*, CNN BUS. (Sept. 24, 2019), https://www.cnn.com/2019/09/24/business/trump-fed-independence-twitter/index.html.

> from the country's trade disputes with China. These government interferences can put into question the Fed's degree of actual institutional and functional independence.[77]

Efforts by Trump to undermine the Fed during his term in office include, in addition to his "numerous tweets . . . calling for lower rates and questioning the Fed's decisions,"[78] his decision not to re-appoint then-Fed Chair, Janet Yellen to a second term, which "was seen by some as breaking with precedent."[79] In addition, on March 22, 2019, Trump nominated his former campaign adviser and co-author of a book on "Trumponomics" for a seat on the Fed's board.[80] The nomination "drew criticism and was ultimately withdrawn."[81] On June 18, 2019, Bloomberg published an article describing how Trump had asked lawyers about the possibility of removing Jerome Powell from his position as Chair of the Board of Governors of the Federal Reserve System.[82] Soon after, on July 2, 2019, President Trump announced his intention to nominate two new candidates for seats on the Board of Governors of the Federal Reserve System. These were the executive vice-president of the Federal Reserve Bank of St. Louis and the President's former economic advisor, who was "an outspoken critic of the central bank's powers to set interest rates and was sympathetic to the gold standard."[83] These actions prompted the issuance of a joint statement by four former Chairs of the Fed expressing support of the Fed's independence and its ability to act without the threat of removal or demotion of its leaders for political reasons.[84]

Economists Thilo Kind, Howard Kung, and Francesco Bianchi have maintained that Trump's frequent attacks on the Federal Reserve are worrisome because they have created a regulatory environment in which "market participants do not believe the Fed is truly independent."[85] These economists find some evidence that Trump influenced the conduct of monetary policy.[86]

While it appears that central bank independence may have bent a bit during the Trump presidency, it did not break. The Fed remained a stalwart opponent of inflation. Equally important, the survey evidence shows that "President Trump's repeated attacks on the Federal Reserve haven't

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77 Rodolfo Dall'Orto Mas et al., *The Case for Central Bank Independence*, 37 (ECB, Occasional Paper Series No. 248, 2020) https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op248~28bebb193a.en.pdf.

78 *Id.* at 57.

79 *Id.*

80 *Id.* at 38.

81 *Id.* at 57.

82 Kind et al., *supra* note 75; Francesco Bianchi et al., *Threats to Central Bank Independence: High-Frequency Identification with Twitter*, 6 (NBER, Working Paper No. 26308, 2022), https://www.nber.org/papers/w26308.

83 Mas et al., *supra* note 77, at 57.

84 *Id.*

85 Kind et al., *supra* note 75.

86 *Id.*

significantly damaged perceptions of the central bank's independence."[87] The survey results showed that "[s]lightly more than half of the economists surveyed said the president's criticism has had little or no effect on the central bank's perceived ability to make policy decisions independent of political pressure. Another 42% said the Fed's independence has been only modestly undermined."[88] Thus, it appears that, at least so far, the Fed remains politically independent. This continued independence is a major source of stability for financial markets and goes a long way in explaining why the political turmoil in the United States has not, so far at least, had a significant negative effect on U.S. financial markets.

THE SEPARATION OF OWNERSHIP AND CONTROL

Another significant institutional protection for U.S. capital markets lies in the fact that stock ownership in the United States is very widespread, particularly among the population of likely voters. It would be political suicide for any politician to embrace policies that threated the financial health of such a wide swathe of the population. In the spring of 2023, Gallup reported that 61 percent of U.S. adults owned stock, the highest level of stock market investing recorded since 2008.[89] In the key demographic of households earning $75,000 or more annually, stock ownership exceeded 80 percent.[90] With the exception of young adults (defined as those under 30), where only 41% of the cohort owns stock, strong majorities of all other age cohorts are invested in the stock market.[91] Unsurprisingly, stock ownership correlates most strongly with household income. More than eight in ten Americans with an annual household income of $75,000 or more own stock, including 80% of those with an income between $75,000 and $99,999 and 84% of those with an income of $100,000 or more.[92] About half of Americans in households earning between $30,000 and $74,999 own stock (51%), as do roughly one in four of those earning less than $30,000 (24%).[93]

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87 David Harrison, *President Trump's Criticism of the Fed Hasn't Shifted Perception of Its Independence, Economists Say*, WALL ST. J. (July 12, 2019), https://www.wsj.com/articles/president-trumps-criticism-of-the-fed-hasnt-shifted-perception-of-its-independence-economists-say-11562925601.

88 *Id.*

89 Jeffrey M. Jones, *U.S. Stock Ownership Highest Since 2008*, GALLUP (May 24, 2023), https://news.gallup.com/poll/506303/stock-ownership-highest-2008.aspx.

90 *Id.*

91 *Id.*

92 *Id.*

93 *Id.*

This dispersion of share ownership is important because, unsurprisingly, political instability harms stock prices.[94] In the month after Trump's unexpected election victory on November 8, 2016, the stock market experienced a five percent gain in a month.[95] The stock market continued to perform well, notwithstanding a looming trade war with China and Trump's first impeachment, at least until the coronavirus dragged the global economy down.[96] Trump was quick to take credit for the bull market, tweeting about "his success" over 150 times.[97] All in all, Trump's term in office was good for the stock market, with the S&P up 56% during the four-year period.[98] While the performance of the stock market during Trump's presidency was strong in historical terms, President Obama's was better, particularly during his first term in office. The Dow gained 72% during President Obama's first term, 14 percentage points better than it did during Trump's term, though the market during Trump's presidency outpaced the 46% rise during Obama's second term.[99]

In his bid for reelection, Trump loudly pandered for votes based on the performance of the stock market during his presidency. For example. On July 6, 2020, Trump tweeted:

> If you want your 401k's and Stocks, which are getting close to an all time high (NASDAQ is already there), to disintegrate and disappear, vote for the Radical Left Do Nothing Democrats and Corrupt Joe Biden. Massive Tax Hikes - They will make you very poor, FAST![100]

The point here is that the widespread ownership of equity, combined with voters' tendency to blame presidents for poor stock market performance, makes the president captive to the stock market. Stock market performance has been identified as "an important explanatory variable in determining the popular vote."[101] Rising stock prices have been found to "result in voters

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94 Hira Irshad, *Relationship Among Political Instability, Stock Market Returns and Stock Market Volatility*, STUD. IN BUS. & ECON., Aug. 2017, at 70, 70, https://intapi.sciendo.com/pdf/10.1515/sbe-2017-0023.

95 Noel Randewich & Saqib Iqbal Ahmed, *Trump's Stock Market: A Wild Four Years*, REUTERS (Oct. 29, 2020), https://www.reuters.com/article/us-usa-election-markets-stocks-graphic/trumps-stock-market-a-wild-four-years-idUSKBN27E1IC.

96 *Id.*

97 *Id.*

98 Ben Levisohn, *How Trump's Stock Market Performance Stacks Up*, BARRON'S (Jan. 20, 2021), https://www.barrons.com/articles/how-trumps-stock-market-performance-stacks-up-to-other-presidents-51611150990.

99 *Id.*

100 Ben Wershkul, *Here's Who Trump Likes to Blame When the Stock Market Goes Down*, YAHOO FIN. (Sept. 15, 2020), https://www.yahoo.com/video/heres-who-trump-likes-to-blame-when-the-stock-market-goes-down-152234488.html.

101 Richard F. Gleisner, *Economic Determinants of Presidential Elections, The Fair Model*, 14 POL. BEHAV. 383, 384 (1992), https://link.springer.com/article/10.1007/BF00992041.

rewarding the incumbent party candidate for the expected strong performance of the economy. Falling stock prices, on the other hand, cause voters to punish the incumbent party candidate."[102]

Widespread stock ownership makes presidents care about the performance of the stock market. Stock market performance is impacted by political stability. Thus, widespread stock ownership makes presidents care about political stability. This conclusion seems strange in the case of Donald Trump because, while Trump appears to have cared deeply about stock market performance, he does not appear to have cared much, if at all, about political stability. Perhaps the key to this puzzle lies in the fact that Trump lost the election. Trump was the first incumbent to lose a presidential election since George H.W. Bush lost in 1992. Moreover, Trump was the only president in the history of polling to have never garnered the approval of a majority of Americans.[103]

STATE LAW AND CORPORATE LAW FEDERALISM

Two distinctive features of U.S. federalism are the allocation of regulatory authority over corporate governance to the states, and the internal affairs doctrine, which is a choice of law rule that allocates to the state that issues a corporation's corporate charter virtually complete authority to regulate the relationships among the corporation and its shareholders, directors, officers and other agents.[104] As the Supreme Court has observed, "[c]orporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires . . . state law will govern the internal affairs of the corporation."[105]

A distinctive feature of U.S. corporate law is jurisdictional competition for corporate charters. States compete with one another for the business of chartering corporations and other forms of business organizations. Delaware has long dominated this jurisdictional competition, with 67.8 percent of Fortune 500 companies choosing to incorporate in Delaware.[106] A critical feature of Delaware corporate law is its stability. As Roberta Romano showed, Delaware is an attractive place for business to incorporate because the state's dependency on the significant tax revenues it receives from corporate

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102 *Id.* at 385; *see also* William A. Luksetich & William B. Riley, Jr., *The Effects of Economic Factors on Presidential Elections: 1900–1972*, 7 J. BEHAV. ECON. 11 (1978).

103 Alan Greenblatt, *Five Reasons Donald Trump Lost the Presidency*, GOVERNING (Nov. 3, 2020), https://www.governing.com/now/five-reasons-donald-trump-lost-the-presidency.html.

104 RESTATEMENT (SECOND) OF CONFLICT OF LS. § 302 cmt. a (AM. L. INST. 1971).

105 Santa Fe Industries, Inc v. Green, 430 U.S. 462, 479 (1977) (quoting Cort v. Ash, 422 U.S. 66, 84 (1975)); *see also* Business Roundtable v. SEC, 905 F.2d 406, 412 (D.C. Cir. 1990).

106 Pierluigi Matera, *Delaware's Dominance, Wyoming's Dare—Blockchain Companies and the Market for Corporate Charters*, OXFORD BUS. L. BLOG (Mar. 25, 2021), https://blogs.law.ox.ac.uk/business-law-blog/blog/2021/03/delawares-dominance-wyomings-dare-blockchain-companies-and-market.

chartering provides a strong commitment that it will act predictably and not make precipitous or unwelcome changes to the legal landscape that governs the companies chartered there.[107] Delaware laws provide an oasis of stability for American business amidst the current sea of political turmoil.

CONCLUSION

Structural and institutional features of the U.S. legal system appear, at least to date, to have insulated the financial markets from the effects of political instability and rising anti-democratic sentiment. The fact that political turmoil, which has included the January 6, 2001 attack on the Capitol and ongoing election denial has had no discernible effect on financial markets is surprising in light of the broad academic consensus that political instability damages capital markets. In this Article I identified structural and institutional features that explain this puzzle. In particular, institutions that are largely insulated from political pressure, particularly the Federal Reserve and the independent judiciary appear to be a source of strength for the financial markets. I also found that the success of federalism in carving out a distinctive role for state law in corporate governance and in fostering jurisdictional competition for corporate charters has created a system in which state courts, particularly Delaware, can be counted on to create a robust legal environment for business. Finally, I note that politicians are further constrained from acting in ways that damage financial markets by their need for political support from an electorate comprised of people with significant investments in the stock market.

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[107] Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 276–78 (1985) (explaining how Delaware's "commitment to firms," gives it a distinctive advantage over other states); ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 9 (1993) (observing "[t]he extraordinary success of tiny Delaware in the corporate charter market due to its responsiveness to changing corporate demands."); Roberta Romano, *Market for Corporate Law Redux*, *in* 2 THE OXFORD HANDBOOK OF LAW AND ECONOMICS 358, 365 (Francesco Parisi ed., 2017) (showing that "firms changing domicile tend to move from less to more responsive states").

A DISTINCTION WITHOUT A DIFFERENCE: ON THE CASE FOR OIRA REVIEW OF RULES BY INDEPENDENT FINANCIAL REGULATORS

Paul J. Ray[*]

INTRODUCTION

Review of draft regulations by the Office of Information and Regulatory Affairs (OIRA) has been hotly debated from the office's creation.[1] But if the scholarly literature is divided, presidents are not: all presidents since Reagan, Republican and Democrat, have retained OIRA review.[2] Proponents of review usually cite three main benefits. In no particular order, they are the coordination of regulatory policy across the government; improved analysis and hence improved regulatory policy; and consistency of regulations with presidential priorities. By retaining OIRA review, presidents have indicated that, from the vantage point of the Oval Office, the benefits outweigh the costs of review.

From the beginning, OIRA review has excluded the independent agencies, including the independent financial regulators (IFRs) such as the Securities and Exchange Commission (SEC), the Federal Deposit Insurance Corporation (FDIC), and the Federal Reserve (the Fed).[3] This exclusion, too, has been much debated. The purpose of this brief essay is to consider the

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[1] *Compare, e.g.*, Christopher C. DeMuth & Douglas H. Ginsburg, *White House Review of Agency Rulemaking*, 99 HARV. L. REV. 1075, 1076 (1986) (offering an early defense of OIRA review) *with* Alan B. Morrison, *OMB Interference with Agency Rulemaking: The Wrong Way to Write a Regulation*, 99 HARV. L. REV. 1059, 1059–60 (1986) (offering early criticisms of OIRA review).

[2] President George H.W. Bush retained Reagan's Executive Order 12291. President Clinton replaced E.O. 12291 with E.O. 12866, which each succeeding president has embraced (sometimes with modifications). *See, e.g.*, Exec. Order No. 14094, Modernizing Regulatory Review, 88 Fed. Reg. 21879, 21879 (Apr. 6, 2023) ("supplement[ing] and reaffirm[ing] the principles, structures, and definitions governing contemporary regulatory review established in Executive Order 12866" while amending one provision of that order).

[3] *See* Exec. Order No. 12291, 46 Fed. Reg. 13193, § 1(d) (Feb. 17, 1981); Exec. Order No. 12866, Regulatory Planning and Review, 58 Fed. Reg. 51735, § 3(b) (Sept. 30, 1993).

extension of OIRA review to the IFRs. In doing so, I draw on both scholarly literature and my own experience as Administrator of OIRA.

A comprehensive examination of the benefits and costs of extending OIRA review to the IFRs would require a much longer article than this one. My purpose is more limited: I aim to show that these benefits and costs would be more or less the same as the benefits and costs of review of executive agency[4] rules. Extension of OIRA review to the IFRs thus follows from the position taken by every president since 1980 and should (all else equal) be the policy of future presidents who endorse the position of their predecessors. Of course, my argument will not persuade those who believe the costs of OIRA review of executive agency regulations outweigh its benefits.

The essay proceeds in two parts. The first shows that the benefits of OIRA review of IFR regulations are basically the same as the benefits of OIRA review of executive agency rules. The second part shows that the costs of OIRA review, too, are more or less the same for IFRs as for executive agencies. While some differences may distinguish the benefits and costs of review of executive agency rules from those attending the review of IFR rules, those differences are modest and do not call my conclusion into serious question.

I. THE BENEFITS OF OIRA REVIEW

A. *Interagency Coordination*

"OIRA review" is something of a misnomer. That is because regulations submitted to OIRA under Executive Order 12866 are reviewed not just by OIRA, but also by many officials at other agencies and at the White House. The interagency input these officials offer provides one main benefit of OIRA review.

When OIRA receives a draft proposed or final regulation for review, it circulates the draft to agencies and White House offices from whose review the rulemaking would benefit.[5] Some of these reviewers have responsibilities implicated by the regulation; they have, in executive parlance, "equities" in the rulemaking. A reviewing agency may, for example, administer a program that would be affected by the regulation, or it may be responsible for the eventual defense of the regulation in court. A White House reviewer may be responsible to the President for a policy portfolio that touches on the regulation. Other reviewers may lack equities in the rulemaking but nevertheless have information useful to the proceeding. For each draft regulation, OIRA staff identify all agencies with relevant equities and information and solicit

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4 *I.e.*, agencies that Congress has not made independent by statute.

5 *See* Cass R. Sunstein, *The Office of Information and Regulatory Affairs: Myths and Realities*, 126 HARV. L. REV. 1838, 1854–59 (2013) (describing the interagency review process).

their feedback on the draft. OIRA then transmits that feedback to the agency authoring the regulation. The author agency prepares a new draft of the regulation that responds to the feedback it has received; this draft is typically circulated at least to all agencies that provided feedback in the first round of review, giving them the opportunity to comment again. For the most important rulemakings, interagency review may consist of several iterations of this process.

Much of the input that agencies receive in interagency review is in the nature of friendly amendments that help them toward their policy goals. But sometimes a reviewer opposes one or more of the author agency's objectives, often when the reviewer believes those objectives would undermine its own policy goals. When this happens, the OIRA process helps resolve the policy disagreement. OIRA convenes all relevant decision-makers to hash out the disagreement, elevating to progressively more senior officials as needed. Uncommonly, a disagreement may go to the most senior political appointees for resolution or—in extremely rare but important cases—to the President himself.[6]

The benefits of interagency review are plain to see. First, by identifying and resolving policy disagreements, it helps the executive unite around coherent policy goals and thus achieve those goals. Second, it gives each agency access to the information and expertise of the federal government as a whole.

IFRs stand to gain from these benefits just as other agencies do. IFRs badly need coordination. As Professors Freeman and Rossi observe, "a single financial institution or financial product may be subject to regulation by multiple financial regulators, creating the potential for inconsistencies"[7] in the absence of coordination. Or a single statute may be implemented by multiple agencies; for instance, consider the Community Reinvestment Act, which is jointly administered by two independent agencies (the Fed and the FDIC) and one independent bureau (the Office of the Comptroller of the Currency) that is itself a part of an executive agency (the Department of the Treasury).[8] Further, because "[m]uch of the policymaking of the independent agencies is not functionally distinct from that of executive branch agencies[,]"[9] independent financial regulators often regulate on topics of significant interest to executive regulators. For example, consider the topic of climate and finance, the object of recent or ongoing proceedings by (among others) the independent SEC, the Commodity Futures Trading Commission, and the Fed, as well

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6 *See id.* at 1856–58 (describing the elevation process).

7 Jody Freeman & Jim Rossi, *Agency Coordination in Shared Regulatory Space*, 125 HARV. L. REV. 1131, 1148 (2012).

8 *See, e.g.*, Community Reinvestment Act Regulations, 70 Fed. Reg. 44256–01, 44256 (Aug. 2, 2005).

9 Harold H. Bruff, *Presidential Management of Agency Rulemaking*, 57 GEO. WASH. L. REV. 533, 591 (1989).

as by (among others) the executive Departments of Labor and Defense.[10] On these topics and others, independent financial regulators need the coordination provided by OIRA's interagency review process.

Further, independent financial regulators stand to gain from access to the expertise and information of executive agencies, and vice versa. For instance, in crafting its climate disclosure rule, the SEC stood to gain from the Environmental Protection Agency's experience administering its longstanding Inventory of U.S. Greenhouse Gas Emissions and Sinks.[11] Conversely, the expertise of the Department of Justice's Antitrust Division may have information to help the SEC analyze the effects of its rules on competition.[12] OIRA's interagency review would provide a channel for information to flow from executive agencies to the IFRs and vice versa.

To be sure, OIRA's is not the only interagency coordination process. There is also the process run by the Financial Stability Oversight Council (FSOC), chaired by the Treasury Secretary. FSOC counts among its members many of the leaders of the IFRs, such as the chairs of the SEC, the FDIC, and the Fed.[13] Among FSOC's duties are "monitor[ing] domestic and international financial regulatory proposals" and "facilitat[ing] information sharing and coordination among the member agencies and other . . . agencies regarding domestic financial services policy development [and] rulemaking."[14] We may wonder, then, whether FSOC already adequately provides the IFRs with interagency coordination.

But FSOC cannot provide anything like the full range of benefits of OIRA review. FSOC's membership is limited to finance-related agencies,[15] so it cannot coordinate with and provide access to information held by non-finance-related agencies. But as the examples earlier in this section show, IFRs need to coordinate and share information with these agencies, not just with other IFRs. Further, FSOC is limited to addressing threats to financial stability.[16] Many important rulemakings by IFRs fall outside this remit. And FSOC lacks OIRA's long and extensive experience administering

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10 *See, e.g.*, Principles for Climate-Related Financial Risk Management for Large Financial Institutions, 88 Fed. Reg. 74183–01 (Oct. 30, 2023); Department of Labor, *Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights*, 87 Fed. Reg. 73822 (Dec. 1, 2022); Federal Acquisition Regulation: Disclosure of Greenhouse Gas Emissions and Climate-Related Financial Risk, 87 Fed. Reg. 68312 (Nov. 14, 2022); The Enhancement and Standardization of Climate-Related Disclosures for Investor*s*, 87 Fed. Reg. 21334 (Apr. 11, 2022).

11 *See Inventory of U.S. Greenhouse Gas Emissions and Sinks*, ENV'T PROT. AGENCY, https://www.epa.gov/ghgemissions/inventory-us-greenhouse-gas-emissions-and-sinks (last visited Dec. 15, 2023).

12 *See* 15 U.S.C. § 78c(f) (instructing the SEC to "consider … whether the [regulatory] action will promote efficiency, competition, and capital formation").

13 12 U.S.C. § 5321(b)(1).

14 *Id.* §§ 5322(a)(2)(D), (E).

15 *Id.* § 5321(b)(1).

16 *See id.* § 5322(a)(1).

interagency review.[17] In light of these limitations, it is clear that OIRA's interagency process would provide important benefits above and beyond those offered by FSOC.

B. *Cost-Benefit Analysis*

Another main benefit of OIRA review is improved cost-benefit analysis ("CBA"). By CBA I mean analysis that identifies and compares the desirable and undesirable consequences of regulatory action. Some, though not all, agency CBA quantifies costs and benefits.[18] CBA, whether quantitative or qualitative, serves two principal purposes. First, by clarifying the costs and benefits attendant on the various courses of action open to an agency, CBA helps the agency reach better decisions about whether to regulate and, if so, how to do so to best effect. Second, publicly-disclosed CBA helps decision-makers outside the executive branch—most importantly Congress and the voting public—to assess agency regulatory decisions and embrace or disavow them.[19]

Executive Order 12866 requires agencies to submit to OIRA with each draft proposed or final regulation an "assessment of the potential costs and benefits of the regulatory action."[20] Assessments may include both quantified and unquantified costs and benefits.[21] OIRA frequently provides feedback on agencies' CBA, feedback which may call for further exploration of overlooked benefits or costs, test the agencies' assumptions, identify calculation errors, ask for additional disclosures and explanations, and otherwise promote accuracy and transparency.

OIRA review powerfully bolsters agency CBA. In the first place, through their work reviewing thousands of regulations over the decades, the OIRA staff have built up extensive expertise in assessing costs and benefits. OIRA review makes this expertise available to agencies, each of which has

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[17] This lack of experience may explain the "limited role" that FSOC seems to have played in coordinating rulemakings among member agencies. *See* GOV'T ACCOUNTABILITY OFF., GAO-12-151, DODD-FRANK ACT REGULATIONS: IMPLEMENTATION COULD BENEFIT FROM ADDITIONAL ANALYSES AND COORDINATION front matter, 27–28 (2011).

[18] *See, e.g.*, Exec. Order. No. 12866, Regulatory Planning and Review, 58 Fed. Reg. 51735 § 1(a) (Sept. 30, 1993) ("Costs and benefits shall be understood to include both quantifiable measures (to the fullest extent that these can be usefully estimated) and qualitative measures of costs and benefits that are difficult to quantify, but nevertheless essential to consider.").

[19] *See, e.g.*, Robert B. Ahdieh, *Reanalyzing Cost-Benefit Analysis: Toward a Framework of Function(s) and Form(s)*, 88 N.Y.U. L. REV. 1983, 2014–15 (2013).

[20] Exec. Order No. 12866, 58 Fed. Reg. 51735, § 6(a)(3)(B).

[21] *See id.* § 6(a)(3)(C) (requiring quantification, "to the extent feasible," of costs and benefits anticipated from economically significant regulations); OFF. OF MGMT. & BUDGET, EXEC. OFF. OF THE PRESIDENT, OMB CIRCULAR. No. A-4, REGULATORY ANALYSIS 44 (2023) (preferring "[s]ound quantitative estimates of benefits and costs, where feasible, [over] qualitative descriptions of benefits and costs").

much less experience than OIRA with CBA.[22] Further, because the OIRA staff are generally not privy to the development of a given regulation or beholden to the author agency, they can provide an important outside perspective and check on agency CBA. Indeed, the mere knowledge of eventual review by OIRA prompts higher-quality agency CBA.[23] By leading to CBA that more accurately accounts for the benefits and costs of regulatory action, OIRA review sets agencies up to make better decisions about whether and how to regulate. Likewise, it assists Congress and members of the public to form truer notions of the effects of regulations and therefore to make better-informed decisions about whether to accept or reject those decisions through legislation and elections.

IFRs need the benefits of sound CBA just as executive agencies do. Some scholars have argued that financial rulemakings tend to be less susceptible to quantified CBA than other kinds of rulemakings.[24] It is not my purpose here to dispute that position. My point is more basic: IFRs, as other agencies, need to give careful consideration (quantitative or qualitative as the nature of the case demands) to the likely consequences of their regulations—a point that even scholars skeptical of quantified CBA for financial regulations readily concede.[25]

OIRA review would strengthen IFRs' CBA in much the same way that it strengthens executive agencies'. OIRA has broad and deep experience reviewing both quantitative and qualitative CBA. This experience equips OIRA staff to illuminate IFRs' assessment of costs and benefits, regardless of whether that assessment is predominantly quantitative or qualitative; there is no reason to believe that the OIRA staff's insights are less valuable where qualitative analysis is concerned. Further, there is every reason to believe OIRA's outside perspective would provide as valuable a check on CBA by IFRs as by executive agencies. True, the subject matter of some IFR regulations is quite complex and arcane, and IFR staff may well have deeper expertise in it than do OIRA staff. But that comparison does not distinguish IFR regulations from regulations by a number of executive agencies which also regulate in complex, highly specialized fields.

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22 *See, e.g.*, Gillian E. Metzger, *Through the Looking Glass to a Shared Reflection: The Evolving Relationship Between Administrative Law and Financial Regulation*, 78 L. & CONTEMP. PROBLEMS 129, 153 (2015).

23 *See, e.g.*, Ryan Bubb, *The OIRA Model for Institutionalizing CBA of Financial Regulation*, 78 L. & CONTEMP. PROBLEMS 47, 50 (2015).

24 *See, e.g.*, John C. Coates IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, 124 YALE L.J. 882, 999–1003 (2015).

25 *See id.* at 1009 ("[I]t is hard to imagine conducting any sort of policy analysis without at least engaging in tacit conceptual" CBA).

C. *Democratic Responsiveness*

The third major benefit of OIRA review is enhancing the democratic responsiveness of the regulations that OIRA reviews. OIRA review creates opportunities for a wide range of executive officials to review draft regulations. Among them are political appointees, both at agencies and at various White House offices such as the Domestic Policy Council and the National Economic Council. These appointees often hold their positions on the basis of their alignment with the President's vision on the policy issues entrusted to their care.[26] Further, the many rewards a president can bestow on faithful and successful lieutenants, as well as the penalties of perceived ineffectiveness, give them incentives to implement (and to be seen to implement) that vision. OIRA's interagency review gives these officials the chance to provide feedback that, if accepted, brings regulations closer to the President's policy vision.

Of course, OIRA review also creates opportunities for officials to inject views that diverge from the President's. But elevation within the OIRA process tends to winnow out such divergent views. For one thing, elevation sends a disagreement to more senior officials who are likely to have greater access to the President and his policy vision and who presumably have been selected for their posts with greater care to ensure their alignment with that vision. For another, officials who believe the President would sustain their position have, all else equal, stronger incentives to seek elevation than officials engaged in advocacy of their own pet policies. And as a dispute moves higher up the chain of command and thus closer to the President, officials experience increased incentives to take positions they would be able to defend, if called upon to do so, before the President or someone holding his proxy. The upshot is that the elevation process tends to help agencies discover the President's views on the subjects on which they propose to regulate.

This discovery in turn can make regulations more responsive to the policy views of an electoral majority of Americans. That is because presidents are representative: they are elected by the people and have powerful incentives to pursue policies that an electoral majority supports.[27] To be sure, presidents transmit majority views imperfectly;[28] nevertheless, when all is said and done, presidential input is likely to result in regulations more closely aligned with these views than regulations lacking such input.

IFRs stand to benefit from presidential input just as much as executive agencies. After all, IFRs' regulations, like executive agencies', implicate just

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[26] *See* David J. Barron, *From Takeover to Merger: Reforming Administrative Law in an Age of Agency Politicization*, 76 GEO. WASH. L. REV. 1095, 1130–31 (2008).

[27] *See, e.g.*, Elena Kagan, *Presidential Administration*, 114 HARV. L. REV. 2245, 2334–35 (2001).

[28] *See, e.g.*, Robert A. Dahl, *Myth of the Presidential Mandate*, 105 POL. SCI. Q. 355 (1990).

the sort of political questions for which democratic responsiveness is vital. Few beliefs from the early days of administration have fared as poorly as the notion that administration can be cordoned off from politics;[29] it is now perfectly clear that the IFRs and other commissions resolve the same sorts of policy questions that the people's representatives do.[30] If democratic responsiveness is important for the resolution of these questions by both Congress and the executive agencies, it is important for the IFRs, too.

Nor do the statutes administered by the IFRs guarantee such responsiveness on their own. If anything, these statutes tend to be more open-ended than those administered by executive agencies[31] and hence more in need of democratically-responsive direction. Many of these statutes rely on essentially contentless terms that can give no guidance. The SEC, for instance, enjoys authority to make rules that are "necessary or appropriate" to protect investors and "insure fair dealing" in securities or the "fair administration" of securities exchanges.[32] Giving content to these and similar terms demands the kind of evaluative judgments that are at the heart of politics and for which democratic responsiveness is critical.

II. THE COSTS OF OIRA REVIEW

Even the most beneficial processes come with costs, and OIRA review is no exception. Many of the costs IFRs would experience are plainly the same as those executive agencies bear. But two kinds of costs may at first glance seem higher for IFRs: the transaction costs of rule issuance and the costs to IFR independence.

A. *Transaction Costs*

Most IFRs are multi-member commissions, and rulemaking typically requires the concurrence of multiple commissioners. The commissioners may well not see eye to eye, so rulemaking may involve considerable costs as the commissioners negotiate among themselves, driving up the staff resources necessary for rulemaking and drawing out the timeline for completion of rules. We may wonder whether the costs of these negotiations would make OIRA review more costly for IFRs than for executive agencies, since (unlike in the case of executive agencies) each OIRA passback could

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29 *See, e.g.*, Woodrow Wilson, *The Study of Administration*, 2 POL. SCI. Q. 197, 212, 215 (1887).

30 *See, e.g.*, Lloyd N. Cutler & David R. Johnson, *Regulation and the Political Process*, 84 YALE L.J. 1395, 1399 (1975).

31 *See, e.g.*, Cass R. Sunstein, *Constitutionalism after the New Deal*, 101 HARV. L. REV. 421, 478–80 (1987).

32 15 U.S.C. §§ 78m(a), 78s(c), 78w(a)(1).

precipitate new negotiations among the IFR commissioners.[33] It is not difficult to imagine commissioners coming to rest on a draft proposal after extensive deliberation only to go back to the drawing board after receiving adverse feedback from OIRA.

I think this concern is considerably overstated. For one thing, executive agency rulemakings also often involve extensive intra-agency coordination.[34] For an executive agency as for an IFR, responding to an OIRA passback may well involve complex negotiations among various officials and offices.[35] It is far from clear that negotiations at IFRs are more costly than at complex executive agencies.

For another thing, IFRs and OIRA have options to limit the transaction costs of OIRA review by modifying the review process. OIRA's 2018 memorandum of understanding with the Treasury Department about the review of tax regulations illustrates the point. There, OIRA and Treasury agreed to an accelerated timeline for the review of tax regulations: 45 days for most tax regulations and an ultra-speedy 10 days for designated Tax Cuts and Jobs Act regulations.[36] OIRA and Treasury also agreed to a phase-in period for certain analytic requirements for CBA accompanying tax regulations.[37] These provisions curtailed the costs, in both staff resources and rulemaking delay, of OIRA review; they would have the same effect if employed in the context of OIRA review of IFR rules. And OIRA and IFRs have a number of other options for ensuring that OIRA review of IFR rulemakings would not unduly drive up the transaction costs of IFR rulemakings.[38] In light of these options, while IFRs' multi-member structure may mean that the transaction costs of OIRA review are somewhat higher than for executive agencies, this difference is not bound to be large.

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33 *See* Cary Coglianese, *Improving Regulatory Analysis at Independent Agencies*, 67 AM. UNIV. L. REV. 733, 747–48 (2018).

34 *See* Anya Bernstein & Cristina Rodriguez, *The Accountable Bureaucrat*, 132 YALE L.J. 1600, 1628 (2023).

35 *Cf.* Jennifer Nou & Edward H. Stiglitz, *Regulatory Bundling*, 128 YALE L.J. 1174, 1198 (2019) ("[E]ven in single-headed agencies, regulatory drafting involves many internal constituencies with conflicting points of view.").

36 *Memorandum of Understanding, The Dep't of the Treasury and the Off. of Mgmt. and Budget Review of Tax Regulations Under Exec. Order 12866* (Apr. 11, 2018), https://home.treasury.gov/sites/default/files/2018-04/04-11%20Signed%20Treasury%20OIRA%20MOA.pdf.

37 *Id.*

38 For an excellent discussion of the various design options that OIRA and independent agencies may consider, *see* Bridget C.E. Dooling, *Bespoke Regulatory Review*, 81 OHIO ST. L.J. 673, 715–17 (2020).

B. *Costs to IFR Independence*

Perhaps the most intensely-felt concern about extending OIRA review to IFRs is that doing so would give the President power over financial rulemakings that Congress has chosen to withhold from him and that he ought not in any event to have.[39]

To understand why these concerns are overstated, we first need to see that agency independence exists on a spectrum. There is no "independence switch" that Congress toggles on or off; rather, Congress chooses among provisions that facilitate or impede presidential control in varying degrees.[40] Take the quintessential marker of agency independence, for-cause removal protection.[41] Forbidding the President to remove an agency head except for cause renders the agency head less dependent on the President's favor and therefore less incentivized to follow his direction. But it does not insulate him entirely from presidential influence, for the President retains many means to sway agency action, from the promise to bless the agency head's future political ambitions to the threat to withdraw support for the agency's budgetary needs.[42] Much the same can be said for other protections Congress may employ; each reduces presidential influence, but none eliminate presidential influence entirely. The many channels of presidential influence explain why presidents can, and do, influence the action of even independent agencies.[43]

Congress is doubtless aware that presidential influence flows through many channels, so we should not read statutes blocking some of those channels as attempting to confer total independence from presidential influence. Indeed, Congress has chosen to *enhance* some kinds of White House influence over independent agencies[44]—a choice that shows Congress's acceptance of some sorts of presidential guidance of even independent agencies. The better reading of the relevant statutes is that Congress means just what it says: it intends agency heads to enjoy just those protections that it

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[39] This essay does not address the constitutionality of provisions conferring various forms of insulation from presidential control.

[40] *See* Kirti Datla & Richard L. Revesz, *Deconstructing Administrative Agencies (and Executive Agencies)*, 98 CORNELL L. REV. 769, 825–27 (2013).

[41] *See, e.g.*, Marshall J. Breger & Gary J. Edles, *Established by Practice: The Theory and Operation of Independent Federal Agencies*, 52 ADMIN. L. REV. 1111, 1138 (2000).

[42] *See, e.g.*, Aziz Z. Huq, *Removal as a Political Question*, 65 STAN. L. REV. 1, 27–32 (2013) (listing various means of presidential control of agencies).

[43] A well-known example is President Obama's successful call for a robust net neutrality rule from the Federal Communications Commission. *See* Haley Sweetland Edwards, *Inside Obama's Net Neutrality Power Play*, TIME (Nov. 11, 2014).

[44] Such as in the Paperwork Reduction Act, which gives OIRA authority to review and approve information collection requests even of independent agencies. *See* 44 U.S.C. §§ 3502(1), 3503(b), 3504(c)(1).

gives them in statute, knowing that presidents will use the channels Congress does not block to influence agency heads.[45]

If that's right, then our question is straightforward: we need to ask whether OIRA review of IFR rulemakings would impinge on any of the particular protections with which Congress has surrounded the IFR heads. It would not. OIRA review consists in an exchange of information among author agencies, OIRA, and the broader executive branch. This exchange, even when it involves information about the President's policy preferences, does not violate any statutory protections.[46] To inform an agency head of the President's policy direction is not to terminate him, shorten his tenure, take away his litigating authority, or compromise any of the other protections Congress has afforded. Because Congress has not protected independent agency heads from OIRA review, extending review to IFR rulemakings would not come at a cost to statutory protections. (Of course, this is not to say whether various forms of discipline for failure to follow presidential direction as conveyed through OIRA review would violate the IFRs' statutory protections.)

Yet putting all this aside, some will find the prospect of enhancing presidential power over the financial system troubling. Presidents face strong temptations to use their power to help their supporters at the expense of their opponents—an abuse familiar to the American Founders under the term "faction."[47] Expanding presidential power over the IFRs would create more opportunities for presidential factionalism.

This risk should not be dismissed; indeed, to my mind, the danger of presidential factionalism is one of the most distressing potentials of today's administrative state. But it is not unique to financial rulemakings. Environmental, labor, and health regulations likewise offer extensive opportunities for presidents to form factions; there is no reason to think that financial regulation presents a greater risk of faction than regulations in these other domains. And that is enough to resolve our question here, which is just whether OIRA review of IFR rulemakings presents a different balance of benefits and costs than OIRA review of rulemakings by executive agencies.[48]

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45 *See* Datla & Revesz, *supra* note 40, at 827–36.

46 *See, e.g.*, Extending Regulatory Review Under Executive Order 12866 to Independent Regulatory Agencies, 43 Op. O.L.C. (2019). Nor would a presidential directive to the IFRs to participate in the OIRA process. *See id.*

47 *See, e.g.*, Paul J. Ray, *Lover, Mystic, Bureaucrat, Judge: The Communication of Expertise and the Deference Doctrines* 24 (Gray Ctr. Working Paper No. 23-32, 2023).

48 It may be that monetary policy presents an especially grave risk of presidential factionalism on account of the strong temptation to tamper that presidents would face immediately before an election. *See, e.g.*, Nathaniel Beck, *Elections and the Fed: Is There a Political Monetary Cycle?*, 31 AM. J. OF POL. SCI. 194, 196–97 (1987). But because monetary policy is for the most part not set by regulation, we can put aside this question.

CONCLUSION

At day's end, the benefits and costs of OIRA review of IFR rules would likely be about the same as the benefits and costs of review of executive agency rules. Perhaps they are not *exactly* the same. IFRs already receive some relatively modest interagency coordination from their participation in FSOC. And while I expect OIRA and IFRs could hammer out a review process that minimizes transaction costs, it may be that those costs would nevertheless exceed by some measure the costs of review to executive agencies. But these differences are likely to be modest. Those who find themselves in agreement with the consensus of the last seven presidents about the value of OIRA review, then, have good reason to extend OIRA review to the IFRs.

COMPETING NARRATIVES ON OIRA REVIEW OF TAX REGULATIONS

Kristin E. Hickman[1] *& Bridget C.E. Dooling*[2]

I. INTRODUCTION

In June 2023, the Biden Administration executed an interagency memorandum of agreement (the 2023 MOA)[3] that pulled the plug on Office of Information and Regulatory Affairs (OIRA) review, including an OIRA-facilitated interagency review process and compliance with Executive Order (EO) 12866, for tax regulatory actions.[4] Contrary to some assertions, the 2023 MOA goes further than any of its predecessor agreements by exempting not merely some or most but rather all tax regulatory actions from OIRA review.[5] The move also ended a short-lived effort, memorialized in a 2018 memorandum (the 2018 MOA), that required OIRA review more often in the tax context than had been the case in the past.[6]

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3 Memorandum of Agreement, The Department of the Treasury and the Office of Management and Budget Review of Treasury Regulations under Executive Order 12866 (June 9, 2023), https://www.whitehouse.gov/wp-content/uploads/2023/06/Treasury-OMB-MOA.pdf [hereinafter 2023 MOA].

4 *See* 58 Fed. Reg. 51735 (Oct. 4, 1993); Cass R. Sunstein, *The Office of Information and Regulatory Affairs: Myths and Realities*, 126 HARV. L. REV. 1838, 1854–63 (2013) (describing the general process of OIRA review).

5 In his first public statement about the 2023 MOA, OIRA Administrator Richard Revesz contended that the new MOA merely reverts to the pre-Trump status quo. *See* Marie Sapirie, *A Finale for OIRA Tax Review*, 180 TAX NOTES FEDERAL 349 (July 17, 2023) (quoting Revesz); Admin. Conf. of the U.S., *79th Plenary Session of the Administrative Conference of the United States*, YOUTUBE (June 15, 2023), https://www.youtube.com/watch?v=8pFBBy6WgHU&list=PLziY_gwGrJeajF1zQieETRZXV_L0PtXLJ&index=7&t=2948s (capturing Revesz's response to question from Kristin Hickman at 49:10). As discussed below, this characterization is not correct.

6 *See Treasury, OMB Come to Agreement on Tax Reg Review*, 2018 TAX NOTES TODAY 72-45 (Apr. 11, 2018) (publishing the 2018 MOA); Memorandum of Agreement, The Department of Treasury and Office of Management and Budget, Review of Tax Regulations under Executive Order 12866 (Apr. 11, 2018), https://home.treasury.gov/sites/default/files/2018-04/04-11%20Signed%20Treasury%20OIRA%20MOA.pdf [hereinafter 2018 MOA].

The 2018 MOA was one of several indicators that "tax exceptionalism"—the idea that the uniqueness of tax justifies various departures from the legal and procedural requirements and expectations that we have for other government agencies—was on the retreat.[7] The courts continue to pursue their own rejection of tax exceptionalism in regulatory practice.[8] With the 2023 MOA, the executive branch is sending the opposite signal.

It is tempting in these cynical times to describe either or both of the 2018 MOA and the 2023 MOA in terms of partisan power grabs or bureaucratic turf battles.[9] Amid all of the dramatic back-and-forth over OIRA review of tax regulatory actions, however, we observe instead two competing narratives more oriented toward different conceptions of the public interest. The substantial and important nature of both the federal tax system and tax regulations grounds both narratives, but that might be where the agreement ends. One narrative is that OIRA review brings worthwhile, salutary benefits to the public and the regulatory process in the form of interagency coordination, accountability, analytical rigor, and transparency about agency decision-making. The other narrative is that OIRA review is meddlesome in multiple ways, dismissive of agencies' subject matter expertise, and its analytical methods are not worth the effort they impose. The first narrative sees tax regulatory actions as highly interconnected with the social welfare and regulatory goals of other executive branch agencies, making robust analysis and interagency coordination especially important in the tax context. The other narrative acknowledges the tax system's role in achieving social welfare and regulatory goals other than revenue raising but remains focused principally on the tax system's traditional revenue raising mission and the associated needs of some taxpayers for regulatory certainty to support transaction planning and tax filing deadlines.

To some extent, the claims underlying and advanced by the two competing narratives can be evaluated empirically. In a separate study of several

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[7] For background on tax exceptionalism, *see, e.g.*, Stephanie Hoffer & Christopher J. Walker, *The Death of Tax Court Exceptionalism*, 99 MINN. L. REV. 221 (2014); Patrick J. Smith, *The APA's Arbitrary and Capricious Standard and IRS Regulations*, 136 TAX NOTES 271 (2012); Kristin E. Hickman, *Coloring Outside the Lines: Examining Treasury's (Lack Of) Compliance with Administrative Procedure Act Rulemaking Requirements*, 82 NOTRE DAME L. REV. 1727 (2007).

[8] *See, e.g.*, CIC Services, LLC v. IRS, 141 S. Ct. 1582, 1594 (2021) (allowing pre-enforcement APA challenge against IRS notice to proceed); Mayo Foundation for Medical Education & Research v. United States, 562 U.S. 44, 55 (2011) (rejecting "an approach to administrative review good for tax law only"); *see also* Kristin E. Hickman, *The Federal Tax System's Administrative Law Woes Grow*, 41 ABA TAX TIMES Win.-Spr. (2022) (documenting several circuit court cases and trends).

[9] An extensive academic literature exists discussing these and related motivations for bureaucratic behavior. *See, e.g.*, RACHEL AUGUSTINE POTTER, BENDING THE RULES: PROCEDURAL POLITICKING IN THE BUREAUCRACY 54–84 (2019); JAMES Q. WILSON, BUREAUCRACY: WHAT GOVERNMENT AGENCIES DO AND WHY THEY DO IT [ch. 10] (1989); Mathew D. McCubbins, Roger G. Noll, & Barry R. Weingast, *Administrative Procedures as Instruments of Political Control*, 3 J.L., ECON. & ORG. 243, 273–74 (1987); Terry Moe, *The Politicized Presidency*, *in* THE NEW DIRECTION IN AMERICAN POLITICS 235–71 (John E. Chubb & Paul E. Peterson, eds., 1985).

years' worth of tax regulation preambles, we aim to resolve at least some issues of contested fact.[10] That study is not designed, however, to address the disagreements about priorities and values—e.g., specialized expertise and efficiency versus accountability and transparency—that the two narratives reflect. In other work, we both have advanced arguments in favor of OIRA review, in the tax context and otherwise.[11] Given space limitations, we will not comprehensively reiterate that case here. Instead, in this essay, we engage these normative considerations by evaluating the primary justifications offered for the sea-change reflected in the 2023 MOA's wholesale rejection of OIRA review for tax regulatory actions. Our assessment of those justifications will, in turn, both note when they merely echo more universal objections to OIRA review and also reflect a more pro-OIRA perspective.

II. NOT QUITE THE STATUS QUO ANTE

First, however, let us address claims that the 2023 MOA merely returns tax administration to the status quo prior to the 2018 MOA. In his first public statement about the 2023 MOA, OIRA Administrator Richard Revesz described the new agreement in such terms: "In some ways, we don't see this as a big move; we see this as a return to what had been the status quo under administrations of both parties for about a 40-year period."[12] Mark Mazur, formerly Assistant Secretary of the Treasury in both the Obama and Biden Administrations, suggested similarly: "This is largely a return to the environment that had been in place from the Reagan administration to the Obama administration."[13] Although OIRA review of tax regulatory actions was not a common occurrence before the 2018 MOA, this characterization of the 2023 MOA and the history of OIRA review in the tax context is inaccurate in important respects.

To go back to the beginning, EO 12291 formalized both regulatory impact analysis and OIRA review for executive branch regulations.[14] Temporary agreements between the Treasury Department (Treasury) and OIRA in 1981 and 1982, followed by a more enduring agreement in 1983, exempted

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[10] *See generally* Bridget C.E. Dooling & Kristin E. Hickman, *Pre-Analysis Research Plan for OIRA Review of Treasury Regulations Project*, (Minn. Legal Stud. Rsch. Paper Series, Paper No. 24-1, 2023), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4419190; Bridget C.E. Dooling & Kristin E. Hickman, *Applying the Regulatory Report Card to Tax Regulations*, J. BENEFIT-COST ANALYSIS (forthcoming 2024), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4321211.

[11] *See* Kristin E. Hickman, *An Overlooked Dimension to OIRA Review of Tax Regulatory Actions*, 105 MINN. L. REV. HEADNOTES 454, 465–75 (2021); Bridget C.E. Dooling, *Bespoke Regulatory Review*, 81 OHIO ST. L.J. 673, 694–95 (2020).

[12] *See* Sapirie, *supra* note 5, at 349; Admin. Conf. of the U.S., *supra* note 5, at 49:10.

[13] *See* Alexander Rifaat, *Biden Drops OIRA From Tax Reg Review Process*, 179 TAX NOTES FED. 2068 (June 19, 2023) (quoting Mazur).

[14] Exec. Order No. 12291 (Feb. 17, 1981), 46 Fed. Reg. 13193.

tax regulatory actions from these requirements under certain circumstances.[15] Treasury and OIRA subsequently ratified the 1983 agreement in 1993, after EO 12866 replaced EO 12291.

Specifically, the 1983 agreement between Treasury and OIRA contemplated regulatory review for "legislative regulations that are 'major' as defined in" EO 12291.[16] Although other tax regulations were exempted from OIRA review, Treasury agreed to alert OIRA to major regulations for which OIRA review was waived and non-major regulations "that reasonably could be expected to have a significant economic impact."[17] Finally, Treasury agreed not to publish any regulation in the *Federal Register* without first explaining to OIRA its reasons for concluding that the regulation was either not major or an interpretative rule.[18]

Treasury and the IRS (collectively Treasury/IRS) have maintained for decades that the vast majority of tax regulations are interpretative rules rather than legislative ones, as those terms are understood under the Administrative Procedure Act.[19] It is a position that may have made sense given jurisprudence in the 1970s and before but that courts have since rejected.[20] Presumably as a result of applying that same characterization in interpreting the 1983 agreement between Treasury and OIRA, as a matter of practice, most tax regulatory actions did not undergo OIRA review. Yet, OIRA and tax administration were not complete strangers.

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15 *See id.*; *Treasury Docs Show Agreement Waiving OMB Review for IRS Rulings*, 2016 TAX NOTES TODAY 185-20 (Sept. 23, 2016) (publishing agreements from 1983 and 1993); *see also* Paige A. Foster & Marie Sapirie, *News Analysis: A Historical Perspective of OMB's Review of Tax Rules*, 158 TAX NOTES 1752 (Mar. 26, 2018) (documenting this history).

16 Memorandum of Agreement, Treasury and OMB, Implementation of Executive Order 12291 (Apr. 29, 1983), https://perma.cc/C92M-CRG2 [hereinafter 1983-1993 MOA]. EO 12291 calls for OIRA review of "major rules," whereas EO 12866 calls for OIRA review of "significant regulatory actions," but the definitions and regulatory impact analysis required for the two are very similar.

17 *Id.*

18 *Id.*

19 *See* I.R.S., IRM 32.1.1.2.6 (Sept. 23, 2011); *see also* Michael Saltzman & Leslie Book, IRS Practice and Procedure ¶ 3.02[2][b] (2024) (discussing the legislative versus interpretative character of Treasury regulations); Hickman, *supra* note 7 at 1760–73 (documenting Treasury's assertions and analyzing its claims under evolving jurisprudence). Interpretative rules are also exempt from Administrative Procedure Act notice-and-comment rulemaking procedures. 5 U.S.C. § 553(b).

20 At least, the U.S. Tax Court has rejected such claims several times. On appeal in these cases, the government has not pressed the argument in some time, perhaps to avoid the sort of sweeping and unequivocal holdings that the Tax Court has reached on this issue. *See, e.g.*, Oakbrook Land Holdings, LLC v. Comm'r, 154 T.C. 180, 189–90 (2020), *aff'd* 28 F.4th 700, 722 (6th Cir. 2022); SIH Partners LLLP v. Comm'r, 150 T.C. 28, 40–41 (2018), *aff'd* 923 F.3d 296, 308 (3d Cir. 2019); Altera Corp. & Subs. v. Comm'r, 145 T.C. 91, 115–17 (2015), *rev'd on other grounds*, 926 F.3d 1061, 1082 (9th Cir. 2019). *Cf. Mayo Found. for Med. Educ. & Res.*, 562 U.S. at 57 (holding that both specific and general authority Treasury regulations carry the force of law, albeit for *Chevron* deference purposes). Since *Mayo Foundation*, no court has held that any Treasury regulation is an interpretative rule.

According to reginfo.gov, between OIRA's inception in 1981 and the 2018 MOA, Treasury/IRS submitted 56 regulations to OIRA for review.[21] Of those, the vast majority (44 submissions, or 78%) occurred prior to 1998, and most of those (32 submissions, or 57%) occurred between the 1986 Tax Reform Act and the Clinton administration's 1993 affirmation of the exemption for most tax regulatory actions.[22] Although Treasury/IRS submitted no regulations at all to OIRA for review between 1998 and 2010, it submitted 12 regulations in the near-decade preceding the 2018 MOA.[23] Many of these regulations imposed user fees or standards governing practice before the IRS upon attorneys, certified public accountants, and others.[24] Others were more substantive.[25]

In its 2011 decision in *Mayo Foundation for Medical Education and Research v. United States*, the Supreme Court rejected "an approach to administrative review good for tax law only" and declared that both specific authority and general authority Treasury regulations "carry the force of law."[26] Since that decision, courts generally have rejected claims that tax regulatory actions—Treasury regulations[27] and even some subregulatory IRS notices[28]—are interpretative rules for Administrative Procedure Act purposes.[29] One consequence of these decisions, at least in theory, was to increase the number of Treasury regulations that might be subject to OIRA review under the terms of the 1983 agreement. Again, the terms of that 1983 agreement called for review of "legislative regulations that are 'major.'"[30]

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21 Analysis using data from reginfo.gov (on file with authors).

22 *Id.*

23 *Id.*

24 *See, e.g.*, T.D. 9781, Preparer Tax Identification Number (PTIN) User Fee Update, 81 Fed. Reg. 52766, 2016-35 I.R.B. 274 (2016) (discussing the regulations' significance); T.D. 9668, Regulations Governing Practice Before the Internal Revenue Service, 79 Fed. Reg. 33685, 2014-27 I.R.B. 1 (2014) (designated as "a 'significant regulatory action,' but not economically significant"); T.D. 9527, Regulations Governing Practice Before the Internal Revenue Service, 76 Fed. Reg. 32286, 2011-27 I.R.B. 1 (2011) (designated as "a 'significant regulatory action' . . . inasmuch as it may adversely affect in a material way the economy, a sector of the economy, productivity, competition, or jobs").

25 *See, e.g.*, T.D. 9826, Mortality Tables for Determining Present Value Under Defined Benefit Pension Plans, 82 Fed. Reg. 46388–411 (2017) ("It has been determined that these regulations constitute a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563."); T.D. 9790, Treatment of Certain Interests in Corporations as Stock or Indebtedness, 81 Fed. Reg. 72858, 2016-45 I.R.B. 540 (2016) ("This rule has been designated as a 'significant regulatory action' under section 3(f) of Executive Order 12866 and designated as economically significant.").

26 *Mayo Found. for Med. Educ. & Res.*, 562 U.S. at 55–58.

27 *See Oakbrook Land Holdings, LLC*, 28 F.4th at 722; *SIH Partners LLLP*, 150 T.C. at 40–41, *aff'd* 923 F.3d at 306; *Altera Corp. & Subs.,* 145 T.C. at 115–17, *rev'd on other grounds*, 926 F.3d at 1080–82.

28 *See, e.g.*, Mann Constr., Inc. v. United States, 27 F.4th 1138, 1143–45 (6th Cir. 2022); Green Rock, LLC v. IRS, 654 F. Supp. 3d 1249, 1253 (N.D. Ala. 2023); CIC Servs., LLC v. IRS, 592 F.Supp.3d 677, 683 (E.D. Tenn. 2022); GBX Assoc., LLC v. United States, 2022 WL 16923886, at *43–44 (N.D. Ohio Nov. 14, 2022); Green Valley Investors, LLC v. Comm'r, 159 T.C. 80, 95 (Nov. 9, 2022).

29 *See* Hickman, *supra* note 7, at 1761–73 (citing sources).

30 *See* 1983-1993 MOA, *supra* note 16.

In 2017, EO 13789 directed Treasury and OIRA to review and reconsider their earlier agreements regarding OIRA review and EO 12866 compliance for tax regulatory actions.[31] That executive order followed calls from members of Congress,[32] the Government Accountability Office,[33] and a bipartisan duo of former OIRA administrators[34] to bring the IRS into the OIRA fold. The result was the 2018 MOA, in which Treasury agreed more systematically to conduct regulatory impact analysis under EO 12866 for many of its draft regulatory actions and to send them to OIRA for review before publication.[35]

In summary, OIRA has always played at least some role in tax administration, and arguably could have played a greater role even under the 1983 agreement after the Supreme Court's *Mayo Foundation* decision. By comparison, the 2023 MOA is clear, unequivocal, and comprehensive in exempting any and all tax regulatory actions from EO 12866 compliance and OIRA review. After ratifying that other regulatory actions taken by Treasury generally will be subject to OIRA review and EO 12866 compliance, the 2023 MOA lists several types of regulatory actions that "will not be subject to such review process."[36] The first item on that list is "[t]ax regulatory actions, defined as a regulatory action (as defined by Executive Order 12866) issued by the Internal Revenue Service whether pursuant to Title 26 of the United States Code or with respect to any other United States Federal income, excise, estate, gift, or employment tax."[37] This means that, for the first time ever, all tax regulatory pronouncements would fall within the exclusion.

III. JUSTIFICATIONS AND RESPONSES

Why should tax regulatory actions be exempt from the requirements of EO 12866 and OIRA review that other executive branch agencies must follow? Biden administration officials and tax experts have offered several

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31 Exec. Order No. 13789 § 2(c), 82 Fed. Reg. 19317 (Apr. 26, 2017) (Identifying and Reducing Tax Regulatory Burdens).

32 *See, e.g.*, Senators Ask OIRA to Review Deal Exempting IRS Regs from Review, 2018 TAX NOTES TODAY 32-24 (Feb. 15, 2018); Hatch Requests Private Treasury memo on Federal Tax Regulations, 2016 TAX NOTES TODAY 85-30 (May 3, 2016).

33 *See generally* U.S. GOV'T ACCOUNTABILITY OFF., GAO-16-720, Report to Congressional Requesters, Regulatory Guidance Processes: Treasury and OMB Need to Reevaluate Long-standing Exemptions of Tax Regulations and Guidance 35 (Sept. 6, 2016).

34 *See generally* Susan E. Dudley & Sally Katzen, *The Story Behind the IRS's Exemption From Oversight*, WALL ST. J. (Feb. 22, 2018, 6:24 PM), https://www.wsj.com/articles/the-story-behind-the-irss-exemption-from-oversight-1519341868.

35 *See* 2018 MOA, *supra* note 6; *see also* Bridget C.E. Dooling, *OIRA's Expanded Review of Tax Regulations and Its Surprising Implications*, 3 BUS. ENTREP. & TAX L. REV. 224, 225 (2019).

36 *See* 2023 MOA, *supra* note 3.

37 *Id.*

reasons. Some reflect common complaints about OIRA review generally, although sometimes with a unique tax twist. Others are more explicitly rooted in tax exceptionalism.

A. *Delay*

One of the most common complaints about OIRA review of tax regulatory actions has been that the OIRA process slows down or delays the release of necessary tax guidance.[38] The 2018 MOA was announced shortly after the enactment of the Tax Cuts and Jobs Act, which tasked the IRS with a huge volume of rulemaking.[39] At the time, many worried that the new MOA would inhibit the timely release of IRS regulations.[40] The question of delay was portrayed as particularly concerning in the tax context, as taxpayers planning transactions, making quarterly estimated tax payments, and filing annual tax returns need the legal certainty that timely guidance provides.

Delay concerns are not unique to the tax context, as OIRA's critics perennially complain that OIRA review slows down the release of important and beneficial regulations.[41] The question, of course, is whether the additional time it takes for OIRA review is "worth it." Framing the issue as one of "delay" implies that a good rule is otherwise being held up by extra, unhelpful process.[42] If, however, OIRA review uncovers and enables agency officials to resolve problems with a regulation before it is issued—including (though not limited to) those that might jeopardize the regulation in subsequent litigation—then characterizing the additional time spent as a "delay" seems less

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38 *See, e.g.*, Naomi Jagoda, *Tax Rules Exempt from White House Review Under New Pact*, BLOOMBERG TAX (June 12, 2023, 1:11 PM), https://news.bloombergtax.com/daily-tax-report/tax-regulations-exempt-from-white-house-review-under-new-pact (quoting David Kautter, Assistant Secretary of the Treasury for Tax Policy).

39 *See generally* Pub. L. No. 115-97, 131 Stat. 2054 (2017).

40 *See, e.g.*, *Timeliness Key to OMB Review of Tax Regs, ABA Tax Section Says*, 2018 TAX NOTES TODAY 82-12 (Apr. 26, 2018); Martin A. Sullivan, *Economic Analysis: OMB-Treasury Memo Creates Guidance Uncertainty and Delay*, 159 TAX NOTES TODAY 443 (Apr. 23, 2018); *see also* Roger W. Dorsey & Mark Funk, *OIRA Review of Tax Regulations and the Continuing Demise of 'Tax Exceptionalism' In Administrative Law*, 101 Prac. Tax Strategies 8, 8 (2018) (acknowledging concerns about delay in reaction to the 2018 MOA).

41 *See, e.g.*, Peter Ketcham-Colwill, *Presidential Influence Over Agency Rulemaking Through Regulatory Review*, 82 GEO. WASH. L. REV. 1622, 1626–29 (2014); Alan B. Morrison, *OMB Interference with Agency Rulemaking: The Wrong Way to Write a Regulation*, 99 HARV. L. REV. 1059, 1065 (1986); *see also* CURTIS W. COPELAND, LENGTH OF RULE REVIEWS BY THE OFFICE OF INFORMATION AND REGULATORY AFFAIRS (2013), https://www.acus.gov/report/oira-review-report (documenting complaints and statistics regarding the timeliness of OIRA reviews over time).

42 *See, e.g.*, Brian Galle & Stephen Shay, *Admin Law and the Crisis of Tax Administration*, 101 N.C. L. REV. 1645, 1653 (2023) (arguing that increased procedures merely delay IRS's response to important issues).

apt.[43] Internal reviews by, for example, the promulgating agency's general counsel staff or political appointees are more likely to be seen as just part of "the process," and therefore not to be described in this manner.[44]

Somewhat ironically, the time allotted by the 2018 MOA for OIRA review was demonstrably less in the tax context. For most agencies, the time designated for OIRA review of most regulatory actions is 90 days.[45] For tax regulatory actions, the 2018 MOA shortened that time period to 45 days and further offered a mechanism for seeking "expedited release" that limited OIRA review to "no more than 10 business days."[46] When OIRA reviews a regulatory action under EO 12866, it discloses the review start and conclusion dates. While our main study will provide more comprehensive data, the average OIRA review time for tax regulations while the 2018 MOA was in effect was approximately 33 days—with some longer but many shorter—showing that the 2018 MOA timeframes generally were honored in practice.[47]

Timely regulations and guidance are important in many regulatory fields. For example, higher education regulations related to student aid are guided by a "master calendar" designed to recognize the importance of implementing changes in time for the school year.[48] The Medicare program runs on annual rulemakings that adjust payment policy for providers that participate in the program; without timely rules, health care providers do not get paid updated amounts.[49] These regulations come through OIRA for review.[50] For that matter, EO 12866 is quite explicit that even regulations promulgated

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43 *See, e.g.*, THOMAS O. MCGARITY, REINVENTING RATIONALITY: THE ROLE OF REGULATORY ANALYSIS IN THE FEDERAL BUREAUCRACY 118 (1991) (describing several "virtues" of EO 12866-style regulatory analysis and OIRA review, including "[s]ecuring successful judicial review"); Hickman, *supra* note 11, at 465–75 (describing in which EO 12866 and OIRA review help Treasury/IRS comply with Administrative Procedure Act requirements).

44 *See, e.g.*, I.R.S., Internal Revenue Manual § 32.2.6.4 (Nov. 12, 2019) (including circulation of drafts to various personnel, including Treasury officials, among procedural steps for published guidance); § 32.2.7.8 (Oct. 21, 2011) (including final Treasury clearance among procedural steps for published guidance).

45 *See* Exec. Order No. 12866 § 6(b)(2)(B). Review times can be longer or shorter than 90 days. In our study of several years' worth of tax regulation preambles, we will include an assessment of OIRA review times for tax and other regulations. *See* Dooling & Hickman, *Pre-Analysis*, *supra* note 10.

46 *See* 2018 MOA, *supra* note 6, at § 4(a).

47 Analysis using data from reginfo.gov (on file with authors).

48 *See* 20 U.S.C. § 1089.

49 *See* CONG. RSCH. SERV., RL30526, MEDICARE PAYMENT POLICIES 1–2 (Sept. 24, 2010) (describing the system of annual Medicare payment rules).

50 *See, e.g.*, OFF. OF INFO. REG. AFF., OIRA Conclusion of EO 12866 Review (Sept. 16, 2013), https://www.reginfo.gov/public/do/eoDetails?rrid=123408 (documenting OIRA's review of a U.S. Department of Education Federal Family of Education Loans regulation); OFF. OF INFO. REG. AFF., OIRA Conclusion of EO 12866 Review, https://www.reginfo.gov/public/do/eoDetails?rrid=307861 (Mar. 21, 2023) (documenting OIRA's review of a U.S. Department of Health and Human Services Medicare Part D regulation).

in emergency circumstances are subject to OIRA review,[51] notwithstanding that the Administrative Procedure Act's good cause exception otherwise might exempt such rules from notice-and-comment rulemaking procedures.[52] So while the annual cycle of tax-related reporting is certainly important to consider, the tax context is not entirely unique.

One interesting aspect of tax, though, is just which taxpayers have the greatest need or desire for more rapid regulatory guidance. Individual taxpayers whose income comes principally from wages subject to third-party withholding[53] and who claim the standard deduction rather than itemizing[54] have little room to engage in the sort of tax planning supported by the rapid issuance of regulations. Larger firms and high net worth individuals (and their professional tax advisers) are more likely to place value on quicker regulatory guidance from Treasury/IRS to facilitate planning.[55] A key normative question is the extent to which the planning needs of the latter subset of taxpayers should be accommodated at the expense of those of other taxpayers or other good government values such as the interagency coordination and transparent and rigorous decision-making facilitated by OIRA review and EO 12866 compliance.

Cass Sunstein contends that so-called delays attributed to OIRA usually arise because of concerns raised by other agencies in the OIRA-facilitated interagency review process, sometimes even when the promulgating agency has already consulted other agencies regarding a rule's content.[56] Resolving such disagreements before a rule is issued, rather than discovering them after the fact, would seem to improve rather than detract from the regulation quality.[57]

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[51] *See* Exec. Order No. 12866 § 6(a)(3)(D), 58 Fed. Reg. 51735 (Oct. 4, 1993); Michael Asimow, *Interim-Final Rules: Making Haste Slowly*, 51 ADMIN. L. REV. 703, 728 (1999).

[52] *See* 5 U.S.C. § 553(b)(B).

[53] According to a Tax Foundation study, "[f]or most tax filers in the U.S., the largest income number on their own Form 1040 appears on the line where they report wages, salaries, tips, and other compensation for their work," estimated at 66% of total income. Erica York & Michael Hartt, *Sources of Personal Income, Tax Year 2020*, TAX FOUND. (June 28, 2023), https://taxfoundation.org/data/all/federal/personal-income-tax-returns-pi-data.

[54] According to the IRS, more than 87% of individual taxpayers claim the standard deduction. *See* INTERNAL REVENUE SERV., SOI Tax Stats–Tax Stats-at-a-Glance, https://www.irs.gov/statistics/soi-tax-stats-tax-stats-at-a-glance.

[55] *See, e.g.*, OECD, Study into the Role of Tax Intermediaries 6, 13–16 (2008), https://www.oecd.org/tax/administration/39882938.pdf (identifying the most common participants in aggressive tax planning activities and their interest in timely tax guidance).

[56] Sunstein, *supra* note 4, at 1842.

[57] For more on OIRA's role as a coordinator and various other forms of interagency coordination and their implications, see Jim Rossi & Jody Freeman, *Agency Coordination in Shared Regulatory Space*, 125 HARV. L. REV. 1131, 1197–1203 (2012).

In the tax context, some argue that interagency coordination happens without OIRA review.[58] While this is surely true to some extent, two important questions come to mind.

First, are an appropriate range of agencies being consulted, and at an appropriate level within the agency? OIRA sits within the Executive Office of the President, from which vantage point it might be aware of agencies with an interest in draft tax regulations that might not be immediately apparent to Treasury/IRS. Many contemporary tax regulations serve regulatory and social welfare goals beyond mere revenue raising, and OIRA-coordinated interagency review ensures that critical perspectives within the executive branch are taken into account.[59] OIRA review can also create a repeat-player scenario in which agencies more regularly interact with each other in both formal and informal ways, perhaps creating opportunities to avoid issues in the future.

Second, when disputes between Treasury/IRS and other agencies arise, how are they handled? OIRA review creates a structure in which interagency disagreements can be considered and resolved. If it is only Treasury's call whether to take interagency concerns seriously, one wonders if the other agencies consistently get a fair hearing for their concerns, especially if they come from a source with relatively less leverage within the executive branch than Treasury.

B. *Politicization*

Another common complaint is that OIRA review increases the politicization of the tax regulatory process. The politicization concern is not unique to the tax context.[60] On the other hand, tax administrators have always been sensitive to accusations of political bias.

Mostly, concerns about politicization in the tax context relate to tax collection and enforcement—e.g., leaking private tax return information or initiating tax audits to harass and harm political opponents—rather than

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[58] *See, e.g.*, Chye-Ching Huang, *Modernizing Tax Regulatory Review*, YALE J. ON REG. NOTICE & COMMENT BLOG (June 29, 2023), https://www.yalejreg.com/nc/modernizing-tax-regulatory-review-by-chye-ching-huang/; Rebecca Kysar (@rebeccakysar), TWITTER (June 12, 2023, 3:06 PM), https://twitter.com/rebeccakysar/status/1668334063541977094.

[59] *See* Blaine G. Saito, *Tax Coordination*, 38 GEORGIA ST. U. L. REV. 735, 794–96 (2022) (discussing OIRA's role as one element of improved tax coordination).

[60] *See, e.g.*, Simon F. Haeder & Susan Webb Yackee, *Influence and the Administrative Process: Lobbying the U.S. President's Office of Management and Budget*, 109 AM. POL. SCI. REV. 507, 517–18 (2015); Lisa Heinzerling, *Inside EPA: A Former Insider's Reflections on the Relationship Between the Obama EPA and the Obama White House*, 31 PACE ENV'T L. REV. 325 (2014).

regulation drafting.[61] Still, critics assert that OIRA review of tax regulatory actions gives lobbyists and political actors more opportunity to influence the content of tax regulations, instead of relying on the views and subject matter expertise of Treasury/IRS career personnel.[62] Making this point in defending the 2023 MOA, former Assistant Secretary for Tax Policy Mark Mazur seemed to suggest further that the IRS's lack of political appointees—"only two [the Commissioner and the Chief Counsel] . . . in an agency of over 80,000 employees"—results in a comparatively depoliticized regulatory process.[63]

Of course, most of the IRS's 80,000 employees are involved in routine compliance and administrative functions, not rulemaking.[64] Yet, Mazur omits the Office of Tax Policy at Treasury, which is quite political. That office is led by an Assistant Secretary appointed by the President and confirmed by the Senate, and also includes several political Deputies appointed by the Secretary, for the purpose of carrying forth presidential priorities in tax policy, including direct involvement in regulation drafting and approval.[65] By comparison, OIRA has fewer political appointees than Treasury—one Administrator with a couple of political deputies—and, like the IRS, is staffed primarily with career civil servants.[66] There is no indication that OIRA's political appointees and career civil servants are any more susceptible to lobbying than the political appointees and career civil servants at Treasury/IRS.

Regardless, the notion that executive branch tax policy is somehow insulated from political influence is puzzling.[67] Although some tax regulatory

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61 *See, e.g.*, Clinton G. Wallace, *Centralized Review of Tax Regulations*, 70 ALA. L. REV. 455, 483–86 (2018) (discussing concerns about politicization of tax administration and acknowledging the distinction).

62 *See, e.g.*, Jonathan Curry, *Lankford Steps into Odd Role in Oversight of Tax Implementation*, 2018 TAX NOTES TODAY 71-4 (Apr. 12, 2018) (quoting former deputy assistant secretary for tax policy Greg Jenner making this point).

63 *See* Rifaat, *Biden Drops OIRA*, *supra* note 13 (quoting Mazur).

64 *See* Saltzman & Book, *supra* note 19, at ¶¶ 1.02 & 3.02 (describing the IRS's several offices and divisions and what they do, as well as the personnel involved in the regulatory process); *see also IRS Budget & Workforce*, IRS (last accessed March 5, 2024), https://www.irs.gov/statistics/irs-budget-and-workforce.

65 31 U.S.C. § 301(e); U.S. DEP'T OF TREAS., Treasury Order 101-06 (Sept. 20, 2022), https://home.treasury.gov/about/general-information/orders-and-directives/treasury-order-101-06; *see also* OFF. OF TAX POL'Y, U.S. DEP'T OF TREAS., https://home.treasury.gov/about/offices/tax-policy; *see generally* Daniel Bunn, *Personnel is Policy: Biden International Tax Team Edition*, TAX FOUND. (Feb. 4, 2021), https://taxfoundation.org/blog/biden-international-tax-team-treasury/.

66 *Frequently Asked Questions*, OFF. OF MGMT. & BUDGET, https://www.reginfo.gov/public/jsp/Utilities/faq.myjsp#oira (last visited Mar. 25, 2024).

67 *See, e.g.*, Jasper L. Cummings, Jr., *Why They Won't Talk*, 160 TAX NOTES 673 (July 30, 2018) (documenting lobbying and political interference in executive branch tax policymaking apart from OIRA review).

actions are sufficiently minor or technical as to avoid much scrutiny,[68] others inevitably will be politically charged because of the significance of the issues they involve, irrespective of whether OIRA plays a role. Wholly apart from OIRA review, examples abound of Treasury/IRS changing course on pending tax regulations as a result of political pressure from Congress, the President, and presumably outside parties as well.

Regulations adopted in 2016 to curb corporate inversion transactions that expatriated or "stripped" earnings from U.S. taxation offer one such example. For many years, Treasury and many other tax experts considered inversions abusive, but Treasury/IRS maintained that they lacked the statutory authority to prevent inversions through regulations and called upon Congress to act instead.[69] Under pressure from the Obama White House and members of Congress,[70] and supported by academic analysis suggesting possible alternative interpretations of relevant statutory provisions,[71] Treasury /IRS issued first a pair of IRS notices,[72] then temporary regulations,[73] followed by final regulations to curtail inversions.[74] Treasury's change of heart, and the resulting inversion regulations, were the product of enormous political pressure notwithstanding a lack of OIRA involvement.

More recently, guidance implementing Inflation Reduction Act changes to the tax credit for electric vehicle purchases provides another clear example

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68 In fact, many proposed Treasury regulations receive no or only a few public comments. Hickman, *Coloring Outside the Lines*, *supra* note 7, at 1758 (documenting that just under a quarter of Treasury regulation projects from 2003 through 2005 received no comments from the public). Also, OIRA often determined that Treasury regulations were not significant or waived review. *See, e.g.*, Jonathan Curry, *A Look Ahead: Treasury, OIRA to Chart New Territory as Final Regs Flood In*, 161 TAX NOTES 1493 (Dec. 17, 2018) (noting waiver possibility). Our main study will update and further analyze both of these data points. *See* Dooling & Hickman, *Pre-Analysis*, *supra* note 10.

69 Steven Russolillo, *In Opposing Tax Inversions, Treasury's Lew Calls for "Economic Patriotism"*, WALL ST. J. (July 16, 2014).

70 *See, e.g.*, Lindsey McPherson, *White House Eyes Administrative Options on Inversions*, 144 TAX NOTES 660 (Aug. 11, 2014); U.S. Democratic Senators Urge Executive Action to Stop Inversions, 2014 WTD 151-20 (Aug. 5, 2014), https://www.taxnotes.com/tax-notes-today-international/legislation-and-lawmaking/us-democratic-senators-urge-executive-action-stop-inversions/2014/08/06/gvq8; Oliver Duggan, *Barack Obama Attacks 'Corporate Deserters' in Tax Inversion Takeovers*, TELEGRAPH (July 25, 2014), http://www.telegraph.co.uk/finance/10990994/Barack-Obama-attacks-corporate-deserters-in-tax-inversion-takeovers.html.

71 *See, e.g.*, Steven M. Rosenthal, *Professor Shay Got It Right: Treasury Can Slow Inversions*, 144 TAX NOTES 1445 (Sept. 22, 2014); Stephen E. Shay, *Mr. Secretary, Take the Tax Juice Out of Corporate Expatriations*, 144 TAX NOTES 473 (July 28, 2014).

72 *See* Notice 2015-79, 2015-49 I.R.B. 775 (Nov. 19, 2015); Notice 2014-52, 2014 I.R.B. 712 (Sept. 22, 2014). The Internal Revenue Code authorizes Treasury to backdate its regulations to the date of an IRS notice "substantially describing the expected contents of" such regulations. 26 U.S.C. § 7805(b)(1)(C).

73 *See* T.D. 9761, Inversions and Related Transactions, 81 Fed. Reg. 20858 (Apr. 8, 2016), 2016-20 I.R.B. 743 (May 16, 2016).

74 *See* T.D. 9812, Guidance for Determining Stock Ownership; Rules Regarding Inversions and Related Transactions, 82 Fed. Reg. 5388 (Jan. 18, 2017).

of a politicized tax rulemaking process with little OIRA involvement. In 2022, that legislation changed which cars would be eligible for the credit, for example by requiring critical minerals used in the batteries to be extracted in North America or a country with which the U.S. has a free trade agreement, and requiring both a percentage of battery assembly as well as final vehicle assembly to occur in North America.[75] The IRS immediately issued FAQs and other subregulatory guidance to explain to the public which cars would fall within these requirements (and, critically, which would not).[76] Foreign countries complained,[77] and members of Congress lobbied Treasury/IRS to be more flexible in their interpretation of the statute.[78] Responding to the political pressure, the IRS changed its subregulatory guidance and foreshadowed Treasury/IRS intentions to broaden eligibility for the credit in proposed regulations.[79] More lobbying ensued,[80] followed by more adjustments.[81] Proposed regulations issued in April 2023[82] along with updated subregulatory guidance[83] did not end the politicking.[84] Treasury has since issued two

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75 *See* IRC § 30D(d)(1)(G), (e)(1)-(2).

76 *See, e.g.*, *FAQ Outlines Changes to Electric Vehicle Tax Credit*, 2022 TAX NOTES TODAY FEDERAL 159-22 (Aug. 16, 2022); Mary Katherine Browne & Chandra Wallace, *IRS Issues Immediate Guidance as EV Credit Changes Are Enacted*, 176 TAX NOTES FED. 1294 (Aug. 22, 2022).

77 *See, e.g.*, Marie Sapirie, *Supercharging EV Guidance, Maybe*, 177 TAX NOTES FEDERAL 1500 (Dec. 12, 2022); Mary Katherine Browne, *EV Credits Raise Concerns About Foreign Industry Discrimination*, 177 TAX NOTES FEDERAL 748 (Oct. 31, 2022); Alexander Rifaat, *Biden Administration Downplays EV Tax Credit Fears*, 177 TAX NOTES FEDERAL 455 (Oct. 17, 2022).

78 *See, e.g.*, *Manchin Asks Treasury to Limit Clean Vehicle Tax Credit Use*, 2022 TAX NOTES TODAY FEDERAL 239-23 (Dec. 12, 2022); *Warnock Calls for More Electric Vehicle Tax Credit Flexibility*, 2022 TAX NOTES TODAY FEDERAL 186-9 (Sept. 23, 2022).

79 *See, e.g.*, *Anticipated Direction of Forthcoming Proposed Guidance on Critical Mineral and Battery Component Value Calculations for the New Clean Vehicle Credit* (Dec. 29, 2022), https://www.taxnotes.com/research/federal/other-documents/treasury-news-releases/treasury-outlines-new-clean-vehicle-credit-battery-requirements/7fhzw; *Fact Sheet Addresses Clean Vehicle Credit FAQs*, 2022 TAX NOTES TODAY INT'L 250-18 (Dec. 29, 2022); Alexander Rifaat & Lauren Loricchio, *White House Offers EU Potential Reprieve on EV Tax Credits*, 178 TAX NOTES FEDERAL 134 (Jan. 2, 2023); Lauren Loricchio, *EV Credit Guidance Buys Time for Automakers on Battery Rules*,178 TAX NOTES FEDERAL 132 (Jan. 2, 2023).

80 *See, e.g.*, *Lawmakers Ask Treasury Not to Delay Electric Vehicle Credits*, 2023 TAX NOTES TODAY Federal 9-13 (Jan. 11, 2023); Amanda Athanasiou, *Europe Flags Continuing Discrimination in EV Credit Scheme*, 178 TAX NOTES FEDERAL 279 (Jan. 9, 2023).

81 *See, e.g.*, *IRS Modifies Classification Standards for Clean Vehicle Credit*, 2023 TAX NOTES TODAY FEDERAL 24-23 (Feb. 3, 2023); *Fact Sheet Supersedes FAQs on Clean Vehicle Credits*, 2023 TAX NOTES FEDERAL 24-38 (Feb. 3, 2023); Alexander Rifaat, *Treasury Revises Classifications for Clean Vehicle Tax Credit*, 178 TAX NOTES FEDERAL 1043 (Feb. 13, 2023); Joseph Disciullo, *IRS Guidance Addresses New Clean Vehicle Credits*, 178 TAX NOTES FEDERAL 1021 (Feb. 13, 2023).

82 *See* Notice of Proposed Rulemaking, 88 Fed. Reg. 23370 (Apr. 17, 2023).

83 *See, e.g.*, *Updated Fact Sheet Accompanies Proposed Regs on Clean Vehicle Credit*, TAX NOTES (Apr. 10, 2023), https://www.taxnotes.com/taxpractice/credits/updated-fact-sheet-accompanies-proposed-regs-clean-vehicle-credit/2023/04/10/7g91b?.

84 *See, e.g.*, Alexander Rifaat, *White House Rejects Manchin EV Tax Credit Criticism*, 1982 TAX NOTES FEDERAL 177 (Jan. 1, 2024); Alexander Rifaat, *Manchin seeks to Overturn EV Tax Credit Regs*,

additional notices of proposed rulemaking to "supplement" the first[85] and called for a public hearing on the proposed regulations.[86] The IRS continues to "update" its subregulatory guidance.[87] Within statutory limitations, Treasury/IRS willingness to make adjustments to their policies in response to feedback from a variety of sources is laudable. But there can be no doubt that the rulemaking process for implementing changes to the tax credit for electric vehicles has been political from day one, and continues to be so, with at most minimal OIRA involvement.[88]

Meanwhile, much of the media reporting on OIRA review of tax regulations under the 2018 MOA observed that the biggest impact on tax regulations from that process came in the form of increased preamble disclosure and analysis—i.e., transparency, and perhaps better policymaking as a result of additional analysis—rather than substantive changes to the regulations themselves.[89] One can debate whether greater transparency and more analysis are worth the effort, but this pattern is not consistent with the narrative that OIRA review politicizes an otherwise relatively neutral and technocratic regulatory process.

Additionally, while we agree it is normatively correct to guard against the potential for political intrusion into IRS adjudicatory decisions (e.g., in the context of tax collection and enforcement), administrative law considerations of due process have long distinguished between adjudicative and legislative decision-making in the executive branch and afforded each with different levels of protection from different forms of influence.[90] Flattening this

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182 TAX NOTES FEDERAL 182 (Jan. 1, 2024); Amanda Athanasiou, *Canada Consults on Tax Credit Domestic Content Requirements*, 112 TAX NOTES INT'L 410 (Oct. 16, 2023).

85 *See* Notice of Proposed Rulemaking, 88 Fed. Reg. 70310 (Oct. 10, 2023); Notice of Proposed Rulemaking, 88 Fed. Reg. 84098 (Dec. 4, 2023).

86 *See* Notice of Proposed Rulemaking; Notice of Public Hearing, 89 Fed. Reg. 1858 (Jan. 11, 2024).

87 *See, e.g.*, *IRS Updates Clean Vehicle Credit FAQs*, TAX NOTES (Jan. 1, 2024), https://www.taxnotes.com/taxpractice/credits/irs-updates-clean-vehicle-credit-faqs/2024/01/01/7hq9z?; *Fact Sheet Adds, Updates FAQs on Clean Vehicle Credit*, 2023 TAX NOTES TODAY FEDERAL 193-25 (Oct. 6, 2023); *Jason Smith Urges Action to Keep EV Credits Away from Adversaries*, 2023 TAX NOTES TODAY INT'L 180-22 (Sept. 19, 2023); Alexander Rifaat, *Sunak Cautions Biden Against 'Subsidy Races'*, 179 TAX NOTES FED. 1881 (June 12, 2023); *Lawmakers Say EV Credit Guidance May Aid China*, 2023 TAX NOTES TODAY FED. 63-18 (Mar. 31, 2023).

88 According to the preamble to April 2023 notice of proposed rulemaking, OIRA designated the proposed regulations as significant and thus subject to OIRA review. Notice of Proposed Rulemaking, 88 Fed. Reg. 23370 (Apr. 17, 2023). By that date, however, OIRA review was nominal at best given the impending 2023 MOA, and now has been removed from the process entirely. *See* 2023 MOA, *supra* note 3.

89 *See, e.g.*, Andrew Velarde & Eric Yauch, *New OIRA Drafts Reveal Tweaks to TCJA Guidance*, 2019 TAX NOTES TODAY INTERNATIONAL 131-1 (July 9, 2019).

90 *See, e.g.*, Cinderella Career and Finishing Schools, Inc. v. Federal Trade Commission, 425 F.2d 583, 591 (D.C. Cir. 1970) (describing the test for decision-maker disqualification in an adjudicatory context); Assoc. of National Advertisers, Inc. v. Federal Trade Commission, 627 F.2d 1151, 1170 (D.C. Cir. 1979) (describing the test for decision-maker disqualification in the rulemaking context).

distinction for tax is yet another manifestation of tax exceptionalism without corresponding justification.

C. *Cost-Benefit Analysis & Tax*

Under EO 12866, agencies are expected to analyze the costs and benefits of their proposals and to make that analysis available to the public during the comment period of notice-and-comment rulemaking.[91] The application of this cost-benefit analysis (CBA) requirement to tax regulations has been controversial since the 2018 MOA was issued.[92] Critics of OIRA review of tax regulations insist that CBA is inappropriate for the tax context for reasons including (but not necessarily limited to) its failure to take into account either the revenue effects or the distributional effects of tax regulations.[93]

As a threshold matter, some—including the IRS—continue to believe that tax regulations merely implement congressional decisions reflected in tax statutes and do not have independent consequences meriting this kind of analysis.[94] While this may have been true at some point in the distant past, it makes little sense today. The modern Internal Revenue Code includes hundreds of authorizations for Treasury, with IRS's assistance, to adopt rules and regulations to elaborate statutory requirements, fill statutory gaps, and decide how best to achieve congressional goals. In 2006, a New York State Bar Association study identified 550 sections of the Internal Revenue Code specifically authorizing rules and regulations in addition to the general authority to adopt regulations "as needful" contained in IRC § 7805(a).[95] It seems unlikely that Treasury's rulemaking power has diminished since then. The fact that taxpayers must pay taxes and file tax returns even in the absence of regulatory guidance does not negate the reality of the extensive regulatory discretion these provisions give Treasury. In exercising that rulemaking power, Treasury/IRS make their own policy choices that narrow or expand eligibility for deductions and credits, incentivize or discourage private party behavior, and impose or alleviate tax regulatory burdens, in addition to increasing or

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[91] *See* Exec. Order No. 12866, 58 Fed. Reg. 51735 § 6(a)(3)(C) & (E)(i) (Oct. 4, 1993).

[92] *See* Hickman, *supra* note 11, at 456.

[93] *See, e.g.*, Rebecca Kysar (@rebeccakysar), TWITTER (June 12, 2023, 3:06 PM), https://twitter.com/rebeccakysar/status/1668334059158929408 & https://twitter.com/rebeccakysar/status/1668334060580802560.

[94] U.S. GOV'T ACCOUNTABILITY OFF., GAO-16-720, REGULATORY GUIDANCE PROCESS: TREASURY AND OMB NEED TO REEVALUATE LONG-STANDING EXEMPTIONS OF TAX REGULATIONS AND GUIDANCE 21 (Sept. 2016) (discussing Treasury and IRS policies that "any effect of the regulation flows directly from the [Internal Revenue Code]").

[95] N.Y. State Bar Ass'n Tax Section, *Report on Legislative Grants of Regulatory Authority* 2 (2006), https://nysba.org/app/uploads/2020/03/1121-Report.pdf (documenting 550 sections of the Internal Revenue Code containing specific authorizations of rulemaking power to Treasury, in addition to the general authority in IRC § 7805(a) to adopt regulations as it deems them "needful").

reducing tax liabilities.[96] Tax regulations, and the policy choices they reflect, have real-world consequences far beyond who pays a few dollars more (or less) in taxes.

The issue of regulatory discretion is at the heart of another complaint about CBA because to conduct such an analysis one must articulate the ex ante conditions, called the baseline, to compare against the proposed rule.[97] If tax statutes "self-execute" in the manner the IRS and others suggest,[98] with Treasury exercising little or no discretion through regulation, then the issue of selecting an analytical baseline will be simple. No daylight exists between what the statute requires and what the regulation requires, so the regulation offers no costs or benefits to analyze. If a Treasury regulation contains a series of discretionary choices—as we suggest very many Treasury regulations do—then it is these choices that the agency can analyze.

Apart from the fundamental issue of the presence or absence of discretion, some take exception to the idea that CBA treats tax revenue collections as "transfers" instead of "benefits" while administrative and compliance costs count as "costs."[99] As we have written elsewhere, this is to ensure that "both sides of the conceptual ledger" in CBA are appropriately considered, as revenue received by the government is funding that taxpayers must pay.[100] CBA functionally "nets out" revenue effects in this manner by calling them transfers, but this is not due to a value judgment about the clearly essential and beneficial role of taxes for promoting the public good. Although the 2018 MOA expressly excluded revenue effects from the determination of "significance," and thus eligibility for OIRA review in the first instance, it said nothing about how to treat revenue effects for purposes of CBA or other analysis under EO 12866.[101] Perhaps as a result of this misunderstanding, a 2020 Addendum to the 2018 MOA provided expressly that "[r]egulatory impact analyses of tax regulatory actions . . . shall account for transfers (including revenue effects) of tax regulatory actions to the same extent as required under this

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96 *See* Dooling & Hickman, *Applying the Regulatory Report Card*, *supra* note 10.

97 OFF. OF MGMT. & BUDGET, OMB CIRCULAR A-4, REGULATORY ANALYSIS 10–14 (2023) (describing the concept of a baseline in CBA); GREG LEISERSON & ADAM LOONEY, A FRAMEWORK FOR ECONOMIC ANALYSIS OF TAX REGULATIONS 7–9 (2018), https://www.brookings.edu/wp-content/uploads/2018/12/ES_20181220_Looney-OIRA-Tax-Regs.pdf.

98 *See, e.g.*, Leiserson & Looney, *supra* note 97, at 7.

99 *See, e.g.*, Chye-Ching Huang, *Modernizing Tax Regulatory Review*, YALE J. ON REG.: NOTICE & COMMENT BLOG (June 29, 2023), https://www.yalejreg.com/nc/modernizing-tax-regulatory-review-by-chye-ching-huang/; Reuven S. Avi-Yonah & Yosef M. Edrey, *Putting the Public Benefit in Cost Benefit Analysis of Tax Regulations: A Response to Hemel, Nou and Weisbach* (U. of Mich. Pub. L. and Legal Rsch. Paper No. 618, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3228379; Rebecca Kysar (@rebeccakysar), TWITTER (June 12, 2023, 3:06 PM), https://twitter.com/rebeccakysar/status/1668334060580802560; *but see* Daniel J. Hemel & David A. Weisbach, *The Behavioral Elasticity of Tax Revenue*, 13 J. LEGAL ANALYSIS 381, 422–30 (2021) (arguing that increases in tax revenues from behavioral changes should count as societal benefits).

100 Dooling & Hickman, *Applying the Regulatory Report Card*, *supra* note 10.

101 *See* 2018 MOA, *supra* note 6, at §§ 1(c) & 2.

Agreement for non-revenue effects, consistent with section 6(a)(3) of Executive Order 12866."[102]

Others have expressed concern that CBA ignores distributional effects,[103] which is true at least of traditional economic CBA alone. This critique fails to land with force in the context of OIRA review and EO 12866 for two reasons. First, it misapprehends and artificially limits the full scope and purpose of the analysis that EO 12866 requires. Second, it disregards the reality on the ground, both of other agencies that have been including distributional effects in their EO 12866 analysis, as well as Biden administration moves to expand those efforts.

Reflecting the first of these observations, EO 12866 explicitly contemplates consideration of distributional effects by calling upon agencies, "in choosing among alternative regulatory approaches," to "maximize net benefits (including potential economic, environmental, public health and safety, and other advantages; distributive impacts; and equity), unless a statute requires another regulatory approach."[104] Hence, since the George W. Bush administration, the Office of Management and Budget's Circular A-4 has described the analysis agencies should provide in addressing regulatory alternatives as including "a separate description of distributional effects (i.e., how both benefits and costs are distributed among sub-populations of particular concern), so that decisionmakers can properly consider them along with the effects on economic efficiency."[105]

Further, when EO 12866 speaks in terms of analyzing the costs and benefits of regulatory actions, it defines those terms broadly. In describing the costs to be considered, EO 12866 lists not only administrative and compliance costs but also "any adverse effects on the efficient functioning of the economy, private markets (including productivity, employment, and competitiveness), health, safety, and the natural environment."[106] Correspondingly, in speaking of benefits, EO 12866 counsels including not only "promotion of the efficient functioning of the economy and private markets," but also "the enhancement of health and safety, the protection of the natural environment, and the elimination or reduction of discrimination or bias."[107] In neither case

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102 Addendum to the Memorandum of Agreement, The Department of the Treasury and the Office of Management and Budget, Review of Tax Regulations under Executive Order 12866 (Dec. 11, 2020), https://trumpwhitehouse.archives.gov/wp-content/uploads/2020/12/Addendum-to-MOA-12.11.2020.pdf.

103 Rebecca Kysar (@rebeccakysar), TWITTER (June 12, 2023, 3:06 PM), https://twitter.com/rebeccakysar/status/1668334060580802560; Naomi Jagoda, *Tax Rules Exempt from White House Review Under New Pact*, BLOOMBERG LAW NEWS 2023-06-12T13:11:02000-04:00 (June 12, 2023) (quoting Chye-Ching Huang).

104 Exec. Order No. 12866, 58 Fed. Reg. 51735 § 1(a) (Oct. 4, 1993).

105 OMB CIRCULAR A-4, *supra* note 100, at 14.

106 Exec. Order No. 12866, 58 Fed. Reg. 51735 § 6(a)(3)(C)(ii) (Oct. 4, 1993).

107 *Id.* § 6(a)(3)(C)(i).

does EO 12866 limit the analysis to the listed examples.[108] Certainly, nothing in the discussion of costs and benefits contained in EO 12866 so constrains the required analysis as to preclude consideration of distributional effects. The point of the analysis is not merely to add up the quantifiable economic costs and benefits, narrowly construed, and adopt only those regulations where the latter exceed the former. Indeed, for both costs and benefits, EO 12866 takes care to acknowledge that quantification of some costs and benefits may not even be "feasible."[109] Rather, the analysis is meant to be comparative, assessing relative costs and benefits of regulatory alternatives, broadly conceived, and explaining why the discretionary choices that a particular regulation reflects are better than the other possibilities.[110] In other words, the goal is to facilitate transparency and reasoned decision-making, not (in the case of tax regulations) to "tilt[] in favor of revenue-losing regulations."[111]

Turning to reality on the ground, and demonstrating this broader understanding of regulatory costs and benefits, Caroline Cecot and Robert Hahn have documented empirically that other agencies have been including distributional effects in their EO 12866 analysis, although not as often nor as thoroughly as Cecot and Hahn (and others) might like.[112] Analyzing 189 rulemakings of several different agencies across four presidential administrations from October 2003 to January 2021, Cecot and Hahn found that distributional analysis was "rarely conducted" but present: 21% quantified "at least some benefits for a particular group"; 20% quantified "at least some costs for a particular group"; and "2% calculated net benefits for a particular group."[113] Another study by Jerry Ellig of 130 Obama administration preambles found that 20% included a "reasonably thorough" assessment of the distribution (incidence) of benefits and 31% offered a "reasonably thorough" discussion of the distribution (incidence) of costs.[114] In short, including an analysis of distributional effects of agency regulations has not been routine, but it has been done, and with at least sufficient regularity to suggest the absence of any barrier on the part of OIRA and EO 12866 to Treasury/IRS including it as often as they liked.[115]

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108 *Id.* §§ 6(a)(3)(C)(i)–(ii).

109 *Id.*

110 *Id.* § 6(a)(3)(C)(iii).

111 Rebecca Kysar (@rebeccakysar), TWITTER (June 12, 2023, 3:06 PM), https://twitter.com/rebeccakysar/status/1668334059158929408.

112 Caroline Cecot & Robert W. Hahn, *Incorporating equity and justice concerns in regulation*, 18 REGUL. & GOVERNANCE 99 (2024).

113 *Id.* at 105–06.

114 Jerry Ellig, *Evaluating the Quality and Use of Regulatory Impact Analysis: The Mercatus Center's Regulatory Report Card, 2008-2013* 23–24 (2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3191415.

115 *See also* Richard L. Revesz & Samantha P. Li, *Distributional Consequences and Regulatory Analysis*, 52 ENVT'L L. 53 (2022).

One irony of the 2023 MOA is that it works at cross-purposes with efforts to improve distributional analysis as a part of agency decision-making process. As part of an initiative to modernize regulatory review, the Biden administration has taken steps do just that with changes to Circular A-4 and otherwise.[116] Considered collectively, tax regulations surely are among the most redistributive regulations issued by the federal government. By exempting tax regulatory actions from EO 12866 compliance and OIRA review, the 2023 MOA makes the Biden administration's emphasis on distributional analysis look like "an empty gesture."[117] It also effectively carves tax policy, as well as IRS-administered regulatory and social welfare policy, out of the interagency analytical discussions within which the federal government will forge these new methodological approaches.[118] Treasury/IRS are also contemplating ways to consider distributional effects in their own regulatory efforts.[119] Perhaps Treasury and IRS officials are reaching out to and consulting with other agencies in these efforts, as former Biden administration officials claim is the case.[120] Nevertheless, the exceptionalist perspective reflected in the 2023 MOA may instead merely exacerbate Treasury/IRS isolation.[121]

D. *Tax Regulations Are Just Different*

It is a common refrain among tax experts that tax administration ought to be exempt from the requirements and expectations of other agencies because tax is just different from other areas of government regulation. How or why tax is so different may vary depending upon the requirement or expectation in question. In the context of OIRA review, two particular claims stand out.

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116 OMB CIRCULAR A-4, *supra* note 97, at 61–67 (including more robust guidance the inclusion of distributional effects as part of EO 12866 analysis as well as overall emphasis of distributional effects); Presidential Memorandum, Modernizing Regulatory Review, 86 Fed. Reg. 7223, 7223 (Jan. 26, 2021) (directing OMB to "propose procedures that take into account the distributional consequences of regulations").

117 Daniel J. Hemel, *Tax Regulations and The New Cost-Benefit Analysis*, 181 TAX NOTES FEDERAL 1977, 1981 (Dec. 11, 2023). Hemel analogizes this move to exempting the Environmental Protection Agency and the Department of Energy from a hypothetical requirement to analyze climate consequences of agency regulations. *Id.*

118 *See* Dooling, *supra* note 11, at 695, 698–99 (discussing the value of interagency coordination for innovations in analytical standards and methodologies).

119 *See, e.g.*, Julie-Anne Cronin, Portia DeFilippes & Robin Fisher, *Tax Expenditures by Race and Hispanic Ethnicity: An Application of the U.S. Treasury Department's Race and Hispanic Ethnicity Imputation* (Office of Tax Analysis, Working Paper No. 122, 2023), https://home.treasury.gov/system/files/131/WP-122.pdf.

120 *See, e.g.*, Rebecca Kysar (@rebeccakysar),TWITTER (June 12, 2023, 3:06 PM), https://twitter.com/rebeccakysar/status/1668334063541977094.

121 Dooling, *supra* note 11, at 698 (discussing the Securities and Exchange Commission's efforts to build internal analytical capability, on its own, after a series of adverse DC Circuit decisions).

One is that tax regulations are different from those of other agencies because the Internal Revenue Code is self-executing, meaning that its provisions go into effect and taxpayers are required to comply even if Treasury has not issued regulations.[122] A contrasting example is the Clean Air Act, which authorizes the Environmental Protection Agency to adopt air quality standards without specifying except in broad terms what those standards might be.[123] The implication of this assertion is that other regulatory statutes are not self-executing, or that the Internal Revenue Code always is. Either claim is distinctly odd.

Many, or perhaps even most, regulatory statutes are self-executing, imposing prohibitions or requirements that are effective with or without implementing regulations, even as they simultaneously authorize an administering agency to adopt rules and regulations elaborating statutory terms. To consider just one example, the Food, Drug and Cosmetic Act prohibits several acts regarding adulterated or misbranded "food, drug, device, tobacco product, or cosmetic" items, including their manufacture and their delivery or receipt in interstate commerce.[124] Much like the Internal Revenue Code, that statute also includes dozens, if not hundreds, of specific grants of rulemaking power[125] and also broadly authorizes the Secretary of Health and Human Services to adopt rules and regulations as needed "for the efficient enforcement" of its provisions.[126]

Meanwhile, as Andy Grewal has documented, many Internal Revenue Code provisions are not obviously self-executing, instead delegating rulemaking authority to Treasury in terms suggesting that regulations may be required before the provisions become operative.[127] Taxpayers or the IRS may claim in litigation that these provisions are self-executing, and sometimes the Tax Court either agrees or, in the case of tax benefits, grants relief under principles of equity.[128] In short, declaring the Internal Revenue Code as uniformly self-executing and other regulatory statutes as not simply does not comport with a reality that is more complicated.

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122 *See, e.g.*, Rebecca Kysar (@rebeccakysar), TWITTER (June 12, 2023, 4:17 PM), https://twitter.com/rebeccakysar/status/1668351854751645697; *see also* Leiserson & Looney, *supra* note 97, at 7 (making this assertion, but in arguing principally for a post-statutory baseline rather than for exempting tax regulations from OIRA review entirely).

123 *See id*. (offering this example).

124 21 U.S.C. § 331.

125 *See, e.g.*, 21 U.S.C. § 341 (authorizing the Secretary to adopt definitions and standards for food, with specific exceptions and considerations); *id.* § 360f (authorizing regulations to expressly ban devices found to "present[ ] substantial deception and an unreasonable or substantial risk of illness or injury for one or more uses"); *id.* § 360i (authorizing the Secretary to require manufacturers and importers to file reports to ensure compliance with statutory prohibition regarding devices).

126 21 U.S.C. § 371(a).

127 Andy Grewal, *Substance Over Form? Phantom Regulations and the Internal Revenue Code*, 7 HOUS. BUS. & TAX L.J. 42, 43–44 (2006).

128 *Id.* at 49–59 (summarizing cases).

Another way in which defenders of the 2023 MOA contend that tax regulations are different is rooted in the perceptions of regulated parties. In essence, the claim is that "the business community" welcomes tax regulations for the certainty they offer regarding the tax consequences of transactions and dislikes other regulations for the costs they impose.[129] According to Lawrence Axelrod, a former IRS special counsel,

> [T]ax regulations are different from regulations promulgated by other agencies. The business community generally regards regulations as a burden because they often impose new requirements that can be costly. Although tax regulations sometimes shut down aggressive tax planning, and practitioners may not always agree with the regulatory analysis, tax regulations generate certainty. Law firms and accounting firms that are asked to draft opinions for clients on proposed transactions welcome regulations that clarify what the IRS will accept and what it will challenge.[130]

Some tax regulatory actions fit this description—for example, regulations governing transfer pricing, or the prices that affiliated enterprises charge one another for goods and services, especially across tax jurisdictional lines.[131] But however accurate this observation may be for some subset of both tax regulations and other regulations alike, it mistakes a small subset of regulations for the whole. It also disregards that regulatory certainty is valued in many regulatory domains, not just tax.

Many or even most tax regulatory actions serve purposes other than offering clarity in support of the sorts of business transactions described.[132] For several decades, Congress has relied increasingly on the tax system as a favorite vehicle for accomplishing social welfare and regulatory objectives through various tax credits, deductions, exclusions, deferrals, and preferences.[133] Recent tax regulation projects addressed policy questions concerning low-income housing,[134] carbon oxide sequestration,[135] semiconductor

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129 Lawrence M. Axelrod, *Letter to the Editor: No OIRA Review Is Good for Tax Regs*, 179 TAX NOTES FEDERAL 2211 (June 26, 2023).

130 *Id.*

131 I.R.C. § 482 (authorizing Treasury to "distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among" affiliated enterprises as "necessary in order to prevent evasion of taxes or clearly to reflect the income" thereof).

132 *See, e.g.*, Kristin E. Hickman, *Administering the Tax System We Have*, 63 DUKE L.J. 1717, 1746–53 (2014) (categorizing and quantifying Treasury regulations for one five-year period). Our main study will update this analysis. *See* Dooling & Hickman, *Pre-Analysis*, *supra* note 10.

133 *See, e.g.*, Pamela F. Olson, *Woodworth Memorial Lecture: And Then Cnut Told Reagan . . . Lessons from the Tax Reform Act of 1986*, 38 OHIO N.U. L. REV. 1, 12–13 (2011); Edward D. Kleinbard, *Woodworth Memorial Lecture: The Congress Within the Congress: How Tax Expenditures Distort Our Budget and Our Political Processes* 36 OHIO N.U. L. REV. 1, 3 (2010).

134 Section 42, Low-Income Housing Credit Average Income Test Regulations, 87 Fed. Reg. 61489 (Oct. 12, 2022).

135 Section 45V Credit for Production of Clean Hydrogen; Section 48(a)(15) Election to Treat Clean Hydrogen Production Facilities as Energy Property, 88 Fed. Reg. 89220 (Dec. 26, 2023).

manufacturing,[136] and electric vehicle purchases,[137] to name a few. Treasury/IRS are heavily involved in regulating health care, health insurance, and retirement plans as a result of the Affordable Care Act, Employee Retirement Income Security Act, and other statutes.[138] Because of tax exemptions for nonprofit organizations and tax deductions for charitable contributions, tax administrators are deeply engaged in regulating the nonprofit sector. Indeed, one of the IRS's four administrative divisions is dedicated to nonprofit organizations and government entities that are largely or entirely exempt from income taxes.[139] Treasury/IRS are hardly the only subject matter experts in these topics. Indeed, in some of these areas, other federal government agencies arguably possess greater subject matter expertise than Treasury/IRS.

Lastly, and returning to the idea of competing narratives, even those with different views about the value of OIRA review and CBA will agree that the importance of tax regulation cannot be overstated. For those who support a role for OIRA, the impact of tax policy and tax administration on society is precisely what makes it important to analyze regulations in terms of their social impacts. If tax is different, that difference is one that deserves closer inspection and perhaps even more coordination, not less.

CONCLUSION

Amid recent policy turbulence surrounding OIRA's long-time but sporadic review of tax regulations, two competing narratives emerge. Both emphasize the importance of tax regulations, but one emphasizes the uniqueness of tax regulations while the other emphasizes OIRA review's value to the public and the regulatory process. Existing literature has delved into tax exceptionalism as well as the value of OIRA's role and regulatory analysis, and we do not rehash those debates here. Instead, this essay builds upon that literature to assess the primary justifications for the 2023 MOA and its complete removal of the OIRA review process from tax regulation.

The 2023 MOA is not guaranteed to be the end of the story for OIRA and IRS. Congress could step in to impose OIRA review on tax regulations, or a future presidential administration could revisit whether to call tax regulations in for OIRA review.[140] As future policymakers consider whether and

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136 Advanced Manufacturing Investment Credit, 88 Fed. Reg. 17451 (Mar. 23, 2023).

137 Section 30D New Clean Vehicle Credit, 88 Fed. Reg. 23370 (Apr. 17, 2023); *see also supra* at pp. 284–285 and accompanying notes 75–88 (discussing the history of Treasury/IRS rulemaking efforts in this area).

138 *See, e.g.*, Coverage of Certain Preventive Services Under the Affordable Care Act, 88 Fed. Reg. 7236 (Feb. 2, 2023); *see generally* King v. Burwell, 576 U.S. 473 (2015) (addressing a challenge to IRS regulations administering the Affordable Care Act).

139 *At-a-Glance: IRS Divisions and Principal Offices*, IRS, https://www.irs.gov/about-irs/at-a-glance-irs-divisions-and-principal-offices (last updated Mar. 4, 2024).

140 One such bill has been introduced already. IRS Accountability and Transparency Act, S. 2981, 118th Cong. (2023).

how to extend OIRA review again to tax regulatory actions, as well as to traditionally independent financial regulators, the value-laden arguments above are likely to surface again. When that time comes, we hope this essay sheds some light on the nature of the disagreement and how it might be resolved.

ARTIFICIAL INTELLIGENCE REGULATORY SANDBOXES

Ryan Nabil[1]

INTRODUCTION

As leading jurisdictions worldwide—from the European Union to the United Kingdom and Switzerland—develop their approaches to artificial intelligence, regulatory sandboxes for AI are quickly gaining popularity. If such sandboxes are properly designed and implemented, they can be a helpful tool in developing an evidence-based, iterative approach to artificial intelligence regulation.

Regulatory sandboxes are government-run programs that allow start-ups, tech firms, and other entities to offer innovative products and services under close regulatory supervision for a limited period.[2] Companies often receive regulatory guidance, expedited registration, or specific regulatory waivers for the duration of the sandbox testing period.[3] Meanwhile, by supervising and closely interacting with companies, regulators can gain a first-hand understanding of emerging technologies and business models and how

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2 Ryan Nabil, *How Regulatory Sandbox Programs Can Promote Technological Innovation and Consumer Welfare*, COMPETITIVE ENTER. INST. (Aug. 17, 2022), https://cei.org/studies/how-regulatory-sandbox-programs-can-promote-technological-innovation-and-consumer-welfare/; *see also* Dan Quan, *A Few Thoughts on Regulatory Sandboxes*, STANFORD CTR. ON PHILANTHROPY & CIV. SOC'Y, https://pacscenter.stanford.edu/a-few-thoughts-on-regulatory-sandboxes/; *see also What is a regulatory sandbox?*, OFF. GAS & ELEC. MKTS. (2018), https://www.ofgem.gov.uk/sites/default/files/docs/2018/09/what_is_a_regulatory_sandbox.pdf.

3 Since different jurisdictions can design regulatory sandbox programs in different ways and for various purposes, there does not appear to be an academic or regulatory consensus about the definition of a regulatory sandbox. The European Union's recently passed Artificial Intelligence Act describes regulatory sandbox in Article 57 in the context of Member State obligation to establish such programs: "AI regulatory sandboxes established under paragraph (1) shall provide for a controlled environment that fosters innovation and facilitates the development, training, testing and validation of innovative AI systems for a limited time before their being placed on `the market or put into service pursuant to a specific sandbox plan agreed between the prospective providers and the competent authority. Such regulatory sandboxes may include testing in real world conditions supervised in the sandbox." Artificial Intelligence Act, art. 57(5), EUR. PARL. DOC. TA 138 (2024). For a general discussion about regulatory sandboxes and their features, *see, e.g.*, Nabil, COMPETITIVE ENTER. INST., *supra* note 2. Brian R. Knight & Trace E. Mitchell, *The Sandbox Paradox: Balancing the Need to Facilitate Innovation with the Risk of Regulatory Privilege*, 72 S.C. L. REV. 446–53 (2020); Hilary Allen, *Regulatory Sandboxes*, 87 GEO. WASH. L. REV. 580–84 (2019). https://digitalcommons.wcl.american.edu/facsch_lawrev/709.

they are impacted by current or proposed regulations.[4] Such regulatory insights can then form the basis for calibrating regulations, introducing new statutory instruments, repealing cumbersome laws, and pursuing other regulatory reforms. This approach of regulatory experimentation and evidence-based reform can be particularly helpful in regulating sectors experiencing rapid technological changes, such as financial services and healthcare.

The UK's Financial Conduct Authority (FCA) launched the world's first financial technology ("fintech") regulatory sandbox in May 2016 to promote innovation in the financial services sector.[5] Since then, more than 50 jurisdictions worldwide have established regulatory sandboxes in areas ranging from financial technology and insurance to healthcare and automated vehicles.[6] However, while innovative jurisdictions like Hong Kong, Singapore, and South Korea have developed well-known fintech sandbox programs,[7] U.S. regulatory interest in such programs at the federal level has been limited.[8] Although the Consumer Financial Protection Bureau's Office of Innovation created the Compliance Assistance Sandbox and the Trial Disclosure Sandbox in September 2019,[9] they remained limited in scope, with the former allowed to expire in September 2022, along with the Bureau's No Action Letter program.[10] Against the backdrop of federal inactivity, at least eleven state governments launched regulatory sandboxes to promote innovation in fintech and other areas.[11]

Despite the prevalence of fintech sandboxes, the most notable U.S. sandbox has been in the legal services sector. In August 2020, the Utah Supreme Court established a sandbox that permits participating non-lawyer-owned law firms and certain non-legal entities to provide specific legal services (e.g., filling out marriage, business, and immigration forms).[12] Since its establishment, this sandbox has admitted over 30 entities—including

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4 *Id.*

5 *See*, *Key Data from Regulatory Sandboxes across the Globe*, WORLD BANK GRP. (2020), https://www.worldbank.org/en/topic/fintech/brief/key-data-from-regulatory-sandboxes-across-the-globe; *Regulatory Sandbox Lessons Learned*, FIN. CONDUCT AUTH. (Oct. 2017), https://www.fca.org.uk/publication/research-and-data/regulatory-sandbox-lessons-learned-report.pdf.

6 Sharmista Appaya et al., *Global Experiences from Regulatory Sandboxes*, WORLD BANK GRP. at 55, Appendix 3, https://documents1.worldbank.org/curated/en/912001605241080935/pdf/Global-Experiences-from-Regulatory-Sandboxes.pdf (Nov. 11, 2011); *see also* Nabil, COMPETITIVE ENTER. INST., *supra* note 2.

7 Nabil, COMPETITIVE ENTER. INST., *supra* note 2.

8 *Id.*

9 Bureau of Consumer Fin. Prot., Policy on the Compliance Assistance Sandbox, 84 Fed. Reg. 48246 (Sept. 10, 2019); Bureau of Consumer Fin. Prot., Policy to encourage Trial Disclosure Programs, 84 Fed. Reg. 48260 (Sept. 10, 2019).

10 Bureau of Consumer Fin. Prot., Statement on Competition and Innovation, 87 Fed. Reg. 58439 (Sept. 27, 2022).

11 *See* Nabil, COMPETITIVE ENTER. INST., *supra* note 2, at Table 2.

12 *Our History*, UTAH OFF. OF LEGAL SERVS. INNOVATION, (last visited Apr. 20, 2024), https://utahinnovationoffice.org/our-history/.

alternative legal providers ("ALP"), alternative business structures ("ABS"), and intermediary platforms—thereby enabling a level of innovation uncharacteristic of most U.S. fintech sandbox programs.[13] Nevertheless, fintech sandboxes remain the most common type of regulatory sandbox in the United States.[14]

Since the inception of the world's first fintech sandbox programs between 2016 and 2017 and a subsequent second wave between 2018 and 2021, the global landscape for regulatory sandboxes now appears to be undergoing an inflection point.[15] Whereas the earlier interest in regulatory sandboxes was primarily driven by financial technology, it is increasingly driven by artificial intelligence as more countries establish regulatory sandboxes to promote AI innovation. At a time when a growing number of jurisdictions worldwide are formulating their AI policies, regulatory sandboxes can be a helpful tool in pursuing an evidence-based approach to AI regulation.

More specifically, artificial intelligence regulatory sandboxes ("AI sandboxes") can enable regulatory authorities to observe participating firms directly, assess the impacts of various regulations on businesses and consumers, and refine rules accordingly.[16] By providing timely insights into the effects of AI regulations on businesses and consumers across various sectors, AI sandboxes can facilitate a better understanding of the need to calibrate existing and proposed AI regulations. In this manner, regulatory sandboxes can support lawmakers and regulators in adopting a more evolutionary, iterative approach to crafting AI rules.

Considering such benefits, a growing number of jurisdictions have expressed interest in establishing regulatory sandboxes for AI. The UK, which pioneered financial technology sandboxes, is currently exploring different models for establishing AI sandboxes.[17] Across the Channel, the European

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13 *See Activity Report: November 2023*, UTAH INNOVATION OFF. at 4 (Dec. 20, 2023), https://utahinnovationoffice.org/wp-content/uploads/2024/01/Sandbox-November-Activity-Report.pdf.

14 *See* Nabil, COMPETITIVE ENTER. INST., *supra* note 2, at Table 2.

15 Appaya et al., *supra* note 6, at 7, Fig. 2.3, & appendix 3; *see also* Nabil, COMPETITIVE ENTER. INST., *supra* note 2, at tables 1–2.

16 Unless otherwise noted, "AI sandboxes" refers to "artificial intelligence regulatory sandboxes," a term that has been abbreviated for brevity. The term does not encompass "open data sandboxes," which merely provide access to data without any regulatory support. In contrast, "AI innovation sandboxes," like the one offered by Zurich Canton, are included within this broader category since they provide both data access *and* regulatory support. Such distinctions will be especially important to consider if the regulatory design and policy objectives of future AI sandbox programs show considerable divergences. For a more extensive discussion of the Zurich sandbox and how Swiss regulators distinguish between "regulatory sandboxes," "innovation sandboxes," and "open data sandboxes," see the discussion on Switzerland and footnote 152 in Section III. ZURICH CANTON, *Innovation-Sandbox für Künstliche Intelligenz (KI) [Innovation Sandbox for Artificial Intelligence (AI)],* https://www.zh.ch/de/wirtschaft-arbeit/wirtschaftsstandort/innovation-sandbox.html (last visited Apr. 20, 2024).

17 Unless otherwise noted, the terms "fintech sandboxes" and "fintech sandbox programs" refer to *regulatory* sandboxes, as opposed to open data sandboxes and other types of non-regulatory sandboxes. *A pro-innovation approach to AI regulation*, U.K. DEP'T FOR SCI., INNOVATION & TECH., & UK OFF. FOR

Union has recently emerged as a leading advocate of AI sandboxes, with each EU Member State required to develop at least one AI sandbox at the national level.[18] Meanwhile, Switzerland's Zurich Canton has established thematic sandbox programs to promote innovation in several targeted areas,[19] while Norway's data protection authority has also launched an AI sandbox.[20] Beyond Europe, countries such as Brazil, Colombia, and Singapore have either established or are considering similar AI sandbox programs.[21]

In the United States, enacting legislation to create a regulatory sandbox is relatively straightforward, particularly due to the growing availability of boilerplate templates from other jurisdictions. However, attracting a steady stream of applicants and using the sandbox findings to spearhead broader regulatory reforms have proven more challenging for many U.S. sandbox programs.[22] Such difficulties underscore the importance of regulatory design for AI sandboxes, especially considering potential challenges related to developing multiple sandboxes for AI applications in various sectors. Without a careful approach to regulatory design, U.S. lawmakers and regulators might not fully benefit from the full potential of regulatory sandboxes to foster an evidence-based, iterative approach to AI regulation.

There are at least three reasons why policy and legal scholarship on AI sandboxes appears sparse despite their growing regulatory importance. First, regulatory sandboxes, more generally, and AI sandboxes, more specifically, remain a relatively recent concept. Second, although there has been some academic and policy work on regulatory sandboxes, such scholarship often tends to focus on the merits of creating sandboxes rather than the principles of designing effective sandboxes to enable evidence-based policy reform.[23]

Lastly, another reason why regulatory sandboxes might have garnered less attention in the context of U.S. legal scholarship is that fintech and AI sandboxes have been more common overseas than in the United States. Although many U.S.-affiliated authors have produced highly cited works on regulatory sandboxes,[24] notable fintech sandbox programs have primarily been developed overseas.[25] Likewise, there appears to be greater regulatory

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A.I. ¶¶ 96–100 (Aug. 3, 2023), https://www.gov.uk/government/publications/ai-regulation-a-pro-innovation-approach/white-paper.

18 Artificial Intelligence Act, art. 57(1), EUR. PARL. DOC. TA 138 (2024).

19 ZURICH CANTON, *supra* note 16.

20 Tom E. Markussen, *Evaluation of the Norwegian Data Protection Authority's Regulatory Sandbox for Artificial Intelligence*, DATATILSYNET (Dec. 5, 2023), https://www.datatilsynet.no/contentassets/41e268e72f7c48d6b0a177156a815c5b/agenda-kaupang-evaluation-sandbox_english_ao.pdf.

21 *See* Section III for a longer discussion.

22 *See* Nabil, COMPETITIVE ENTER. INST., *supra* note 2, at Table 2.

23 *See, e.g.*, Ivo Jeník, Schan Duf, *How To Build A Regulatory Sandbox*, CONSULTATIVE GROUP TO ASSIST THE POOR (2020), http://documents.worldbank.org/curated/en/126281625136122935/How-to-Build-a-Regulatory-Sandbox-A-Practical-Guide-for-Policy-Makers.

24 *See, e.g.*, Knight & Mitchell, *supra* note 3; Allen, *supra* note 3.

25 *See* Appaya et al., *supra* note 6, at appendix 3.

interest in establishing AI sandboxes overseas—including the European Union, Singapore, Switzerland, and the UK—than in the United States. Interestingly, whereas where Anglophone Common Law jurisdictions like Australia, Hong Kong, and the UK spearheaded the world's first fintech sandbox programs,[26] European Civil Law jurisdictions appear to be playing a leading role in establishing AI sandboxes.[27] Such jurisdictions include Spain, which became the first EU country to enact legislation providing a statutory basis for AI regulatory sandboxes at the national level.[28]

This trend might ultimately lead to greater divergences between global regulatory developments and U.S. legal scholarship on AI sandboxes, especially if statutes, regulations, and other primary source materials are not widely available in English. This Article seeks to address this growing gap in legal and policy scholarship by analyzing changing trends in the global regulatory landscape for AI sandboxes, comparing the sandbox strategies of select jurisdictions, and presenting observations and recommendations that could be helpful for U.S., European, and global policymakers interested in designing effective sandbox programs.

The remainder of this Article is structured as follows: Section I provides a brief overview of the development of regulatory sandboxes in the financial technology sector, tracing their origins in the UK and subsequent diffusion worldwide, including the United States. Section II analyzes the different natures of fintech and AI regulation and explains why the more multifaceted nature of AI regulation necessitates a differentiated approach to regulatory sandboxes for AI. Section III discusses the AI sandbox strategies of jurisdictions that are at the forefront of creating AI regulatory sandboxes as of January 2024, focusing on the UK, the EU, Norway, and Switzerland. This section also examines the challenges these jurisdictions face, especially in terms of regulatory design. Additionally, it also includes a brief discussion of sandbox-related initiatives in several emerging-market nations, including Singapore, China, and Russia, in the interest of a more global approach to legal scholarship. Based on this analysis, Section IV offers a series of general principles and policy recommendations for lawmakers and regulators as they design new AI sandboxes or improve existing ones. It also provides more tailored recommendations for designing effective AI sandboxes in the regulatory contexts of the United States, the European Union, and emerging-market countries. The Article concludes by offering broader observations on the regulatory sandbox's evolving role and its limits as a policy tool in the context of AI regulation.

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26 Nabil, COMPETITIVE ENTER. INST., *supra* note 2, at Table 1; Appaya et al., *supra* note 6, at appendix 3.

27 Examples include the European Union, Norway, Switzerland, and Spain. See Section III for a longer discussion.

28 REAL DECRETO 817/2023 [ROYAL DECREE 817/2023], C.E., B.O.E. n.268 (Nov. 9, 2023), https://www.boe.es/diario_boe/txt.php?id=BOE-A-2023-22767.

I. REGULATORY SANDBOXES IN THE FINANCIAL TECHNOLOGY SECTOR[29]

Fintech sandboxes provide a helpful starting point for understanding the changing global landscape of regulatory sandboxes. As mentioned, the UK's Financial Conduct Authority formally launched the world's first fintech sandbox in May 2016.[30] According to the FCA, the sandbox is open to currently authorized firms, unauthorized firms seeking FCA authorization, and technology firms seeking to offer innovative products and services in the UK financial services market.[31] For firms not yet ready to test new products through the sandbox, the FCA offers an "Innovation Pathway" program, allowing companies to seek regulatory help to better understand the UK's financial regulatory regime.[32] Most recently, in December 2023, the FCA and the Bank of England jointly announced the launch of the Digital Securities Sandbox.[33] The sandbox will be used to calibrate rules for innovative tokenized securities under the 2023 Financial Services and Markets Act, which came into effect on January 8, 2024.[34]

When the FCA launched its fintech sandbox, the concept of regulatory sandboxes was relatively less known than the case today.[35] However, forward-thinking jurisdictions worldwide—such as Australia, Hong Kong, Singapore, Switzerland, and South Korea—designed similar programs to promote financial innovation soon thereafter.[36] According to the World Bank, which conducted a major study of sandbox programs worldwide, 57 jurisdictions created or announced the creation of 73 regulatory sandboxes as of November 2020, a number that has increased since then, especially in the United States and Europe.[37]

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29 This section builds on the author's previous report on financial technology sandboxes. *See generally* Nabil, COMPETITIVE ENTER. INST., *supra* note 2.

30 More specifically, the application window for the first cohort of the FCA sandbox opened in May 2016 and closed in July 2016. *Financial Conduct Authority's regulatory sandbox opens to applications*, FIN. CONDUCT AUTH. (2016), https://www.fca.org.uk/news/press-releases/financial-conduct-authority%E2%80%99s-regulatory-sandbox-opens-applications.

31 *Regulatory Sandbox*, FIN. CONDUCT AUTH., (2022), https://www.fca.org.uk/firms/innovation/regulatory-sandbox#section-who-can-apply-to-the-regulatory-sandbox.

32 *Id.*

33 The Financial Services and Markets Act 2023 (Digital Securities Sandbox) Regulations 2023 No. 1398, Regulation 1, https://www.legislation.gov.uk/uksi/2023/1398/regulation/1.

34 *Id.*

35 *See Lessons Learned*, FIN. CONDUCT AUTH., *supra* note 5.

36 *See*, Appaya et al., *supra* note 6, at appendix 3.

37 The actual number of regulatory sandboxes, even as of November 2020, is likely to be higher since the World Bank study appears to exclude at least several sandboxes that were established in or before 2020. Examples in the context of the United States include state-level fintech and insurance sandboxes in Hawaii, Hawaii, Vermont, West Virginia, and Wyoming. *Compare* Appaya et al., *supra* note 6, at appendix 3, *with* Nabil, COMPETITIVE ENTER. INST., *supra* note 2, at Table 2.

The Asia Pacific and the Europe and Central Asia regions were the geographical areas with the highest reported number of regulatory sandboxes, with 19 and 18 such programs, respectively, as of November 2020.[38] In contrast, South Asia and North America were the regions with the lowest reported number of regulatory sandboxes, with five and six programs, respectively, although the growth of state-level U.S. regulatory sandboxes since then likely means that North America is no longer a region with a relatively low number of sandbox programs.[39] While the number of financial technology sandboxes has increased considerably since 2020, an authoritative estimate of the total number of regulatory sandboxes worldwide does not appear available.

Nevertheless, these numbers should be interpreted with caution. While a high number of sandboxes might reflect a certain degree of regulatory interest in such programs, they do not necessarily reflect whether such sandboxes have been successful in promoting innovation and enabling regulatory reform. On the contrary, a lower number of well-designed and targeted regulatory sandboxes at the national level might be more desirable than a high overall number of state-level sandboxes that struggle to attract participants and promote innovation, as has recently been the case with fintech sandboxes in the United States.[40]

In the United States, the Consumer Financial Protection Bureau (CFPB) created the Compliance Assistance Sandbox Program and the Trial Disclosure Sandbox Program, reportedly the only two sandbox programs at the federal level.[41] However, the lack of regulatory interest from the CFPB under the Biden administration meant that the Compliance Assistance Sandbox program was allowed to expire in September 2022.[42] That was also the case for the CFPB's No Action Letter program, which stated the agency's intention not to pursue enforcement actions against a particular company as long as it complied with specific rules and regulations.[43] Beyond the CFPB, regulators in other agencies—particularly the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC)—

38 Appaya et al., *supra* note 6, at 6, Fig. 2.1.

39 *See id.*

40 Nabil, COMPETITIVE ENTER. INST., *supra* note 2, at Table 2.

41 *See id.* at 1.

42 However, according to the Bureau, "[t]he CFPB will continue to accept and process requests under the Trial Disclosure Policy." Bureau of Consumer Fin. Prot., Statement on Competition and Innovation, 87 FED. REG. 58439 (Sept. 27, 2022).

43 *Id.* While this program might have displayed some features of a sandbox, it was not a proper sandbox in the sense that it does not involve close, continuous regulatory supervision characteristic of traditional sandbox programs, nor are the regulatory insights from such No Action Letter programs used for broader calibration of regulations for all firms.

appear to have expressed interest in sandbox-like initiatives, although the future of such programs remains uncertain due to a lack of regulatory interest.[44]

One particular challenge that U.S. agencies have faced in creating fintech sandboxes at the federal level is regulatory fragmentation.[45] Unlike jurisdictions like Australia, Singapore, and the UK, where fintech sandboxes are well-established, the financial regulatory landscape in the United States is considerably more fragmented. In this regard, Hilary Allen from the American University Washington School of Law provides a demonstrative example of a hypothetical robo-advisor firm in a fintech sandbox, which could simultaneously fall under the jurisdiction of the CFPB and the SEC.[46] If the firm were to offer banking services, it would likely fall under the jurisdiction of the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and state banking regulators.[47] This division of regulatory authority constrains the ability of a particular agency to supervise firms, calibrate regulations, and provide regulatory relief where appropriate.[48] Such constraints—coupled with the absence of a statutory basis for creating the sandbox and mechanisms for interagency coordination—limit the effectiveness of U.S. fintech sandboxes at the federal level.

Against this backdrop, several U.S. state governments have sought to create state-level sandbox programs. At least 11 U.S. states have established regulatory sandboxes so far, which include Arizona, Florida, Hawaii, Kentucky, Nevada, North Carolina, South Dakota, Utah, Vermont, West Virginia, and Wyoming.[49] Notwithstanding such efforts, multiple state-level fintech sandboxes appear to experience difficulties with attracting and admitting sandbox participants.[50] According to a study of regulatory sandboxes from the Competitive Enterprise Institute, only three state-level fintech sandboxes—in Arizona, Hawaii, and West Virginia—admitted at least one sandbox participant as of November 2021.[51] In contrast, 223 firms participated in Hong Kong's Monetary Authority sandbox, while 118 and 150 firms participated in South Korea's Fintech sandbox and Britain's FCA sandbox (excluding the Digital Services Sandbox), respectively.[52] Furthermore, the Utah Supreme Court's legal sandbox admitted more participants than all U.S.

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44 *See* Caroline D. Pham, Comm'r, Commodity Futures Trading Comm'n, Public Statement & Remarks on a CFTC Pilot Sandbox Program (Sept. 7, 2023), https://www.cftc.gov/PressRoom/SpeechesTestimony/opapham9; *see also* Victor Smart, *SEC'S Hester Peirce floats UK-US crypto sandbox idea*, BANKING RISK & REGUL. (July 18, 2023), https://www.bankingriskandregulation.com/secs-hester-peirce-floats-uk-us-crypto-sandbox-idea/.

45 *See* Allen, *supra* note 3.

46 *Id*. at 618.

47 *Id.*

48 *Id*.

49 Nabil, COMPETITIVE ENTER. INST., *supra* note 2, at 2.

50 *Id.* at Tables 1–2.

51 *Id.* at Table 2.

52 *Id.* at Table 1.

fintech sandboxes as of November 2021, a gap that has likely grown further since then as state-level fintech sandboxes have struggled to attract enough quality applications.[53]

While making such *inter*- and *intra*-country comparisons, a certain degree of caution is warranted. A higher number of participating firms does not necessarily mean that the sandbox will facilitate innovation or regulatory reform. Regulatory authorities could successfully pursue policy reforms based on higher-quality supervision and interaction with a smaller set of carefully selected and representative firms—as long as the number of participating companies meets a certain threshold. However, the lack of participants or a meager number thereof, as has been the case in some U.S. fintech sandboxes, can indicate underlying structural issues that limit the effectiveness of such programs in enabling regulatory reform and innovation.[54] Unless U.S. lawmakers and regulators address these underlying issues, such as the lack of adequate interagency coordination mechanisms, AI sandboxes might also suffer from similar challenges.

II. FROM FINTECH TO AI: DO REGULATORY SANDBOXES FOR AI REQUIRE A DIFFERENT APPROACH?

Although fintech regulatory sandboxes have provided the impetus behind creating similar programs for artificial intelligence, designing AI sandboxes requires a differentiated approach. Since AI-enabled applications and systems can be used in a wider range of contexts and sectors, AI regulation is often significantly more multifaceted than fintech regulation. As a result, whereas fintech products and services can be more easily regulated within the scope of the broader financial services sector, AI regulation will likely involve the application of specific AI and data protection regulations, along with the relevant sector rules. This section explores these differences in greater detail and explains what they mean for AI regulatory sandboxes.

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53 According to data from the CEI study, the number of participants in the Arizona fintech sandbox (11), Hawaii Digital Currency Sandbox (16), and West Virginia FinTech Sandbox (1) amount to 28, compared to the number of participants in the Utah Legal Sandbox (31) as of November 2021. Nabil, COMPETITIVE ENTER. INST., *supra* note 2, at table 2. While further research and correspondence are needed to establish the current number of participants in different U.S. fintech sandboxes, preliminary research suggests that the trend of the low number of participants in U.S. fintech sandboxes has not changed substantially since November 2021, the end of CEI's data collection period for this report. In contrast, according to the latest activities report by the Utah Supreme Court Office of Legal Services Innovation, 51 entities have participated in the state's legal sandbox. *See Activity Report*, UTAH, *supra* note 13.

54 *See* Nabil, COMPETITIVE ENTER. INST., *supra* note 2, at Table 2.

A. *Effective AI Regulation and the Need for a Combination of Different Regulatory Sandboxes*

There are several reasons why regulatory sandboxes can be helpful in the context of both fintech and AI regulation. Given the rapid pace of technological innovation, they can bring new fintech products and AI systems into compliance, especially when the precise regulatory requirements are unclear. Likewise, the fintech and AI regulatory landscapes are often characterized by a gap between rapid technological developments and less-developed regulatory capacity. Through close and continuous regulatory contact and supervision, sandboxes can help regulators develop a better understanding of emerging business models and technologies and develop their regulatory expertise.[55] This improved understanding and expertise develop and calibrate evidence-based rules and maintain an innovative regulatory environment.[56]

While regulatory sandboxes can be beneficial for both fintech and AI regulation, the differences in the nature of fintech and AI regulation underscore the need for a differentiated approach to AI sandboxes. Unlike fintech, which can be viewed as a subset of the broader financial services sector, there is no single "artificial intelligence" industry. Instead, AI applications and systems enable various products, services, processes, and other innovations in different sectors, ranging from healthcare to manufacturing and financial services. Furthermore, there is no single legal definition of artificial intelligence or AI systems; instead, the umbrella term refers to a wide range of technological applications and lacks a meaningful international consensus.[57] In contrast, while there are also different types of financial technologies, they are typically applied in the context of the financial services sector. Furthermore, some fintech sandboxes, such as the Hawaii Digital Currency Innovation Lab (DCIL) Sandbox, are geared towards specific types of financial technologies, such as cryptocurrencies and blockchain technologies, meaning that the regulatory scope of such sandboxes can be defined more narrowly.[58]

These differences have important implications for designing regulatory sandboxes for AI. The wider variety of AI systems and applications and the range of sectors where they can be applied means that a single one-size-fits-all sandbox might be less effective for AI than for fintech. Since AI applications cut across various sectors and often involve the jurisdiction of multiple

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55 *Lessons Learned*, FIN. CONDUCT AUTH., *supra* note 5, at 3–4; Allen, *supra* note 3, at 643; Knight & Mitchell, *supra* note 3, at 449–50.

56 *Id.*

57 Rex Martinez, *Artificial Intelligence: Distinguishing Between Types & Definitions*, 19 NEV. L.J. 1015, 1016–17 (2019); Stanley Greenstein, *Preserving the Rule of Law in the Era of Artificial Intelligence (AI)*, 30 A.I. & L 291, 299 (2022), https://link.springer.com/article/10.1007/s10506-021-09294-4.

58 S*ee, e.g.*, HAW. TECH. DEV. CORP., *Digital Currency Innovation Lab*, https://www.htdc.org/digital-currency-innovation-lab/ (last visited Jan. 24, 2023).

regulators, a general-purpose AI sandbox under the supervision of multiple regulators will be appropriate for many AI applications.[59]

However, because AI applications often vary significantly by sector, a general-purpose AI sandbox needs to be complemented with sector-specific or thematic sandboxes under the supervision of the relevant sectoral regulator(s).[60] For instance, regulating AI applications in nuclear energy will require knowledge of energy regulations and applicable AI laws, whereas supervising medical AI applications will require expertise in health law, data protection law, and any applicable AI law.[61] A general-purpose AI sandbox under the primary supervision of a particular jurisdiction's artificial intelligence or data protection regulator is unlikely to possess such sector-specific expertise. Therefore, specialized sandboxes might be more effective in developing context-specific rules tailored to different industries.[62]

While general-purpose AI sandboxes might admit firms from various sectors, this approach might not yield the volume of case studies essential for developing more specialized, sector-specific rules. The need for more specialized sandboxes becomes apparent through Zurich Canton's thematic sandboxes, which have been designed to promote innovation and develop rules for i) automated grading in standardized testing and ii) augmented and virtual reality applications in foreign language instruction, among others.[63] Although a general AI sandbox might be open to developers of such applications, limited regulatory resources generally constrain the number of firms that can be admitted to a general sandbox at any given time. Furthermore, sandbox regulators might seek to ensure representation from a diverse array of sectors. Therefore, general-purpose AI sandboxes are unlikely to have a sufficiently high number of relevant projects needed to develop a nuanced understanding of highly specialized technologies and business models. In contrast, sector-specific or thematic sandboxes, such as those established by Zurich Canton within the framework of a broader AI sandbox program, can generate the volume and variety of projects needed to develop rules for more specialized AI applications.[64] Therefore, it is crucial to supplement general-purpose AI sandboxes with sector-specific or thematic programs to craft context-specific rules for AI across various sectors and specialized settings.[65]

59 U.K. DEP'T FOR SCI., *supra* note 17.

60 *See id.* at ¶¶ 96–98.

61 *See also* Ryan Nabil, *Global AI Governance and the United Nations*, YALE J. INT'L AFFS. (Fall 2023), https://www.yalejournal.org/publications/global-ai-governance-and-the-united-nations.

62 *See, e.g.*, U.K. DEP'T FOR SCI., *supra* note 17, at ¶ 95–98.

63 ZURICH CANTON, *supra* note 16.

64 *Id.*

65 *See, e.g.*, *id.*

B. *Regulatory Sandboxes as a Tool for Evidence-Based, Iterative Approach to AI Regulation*

When the first and second waves of fintech sandbox programs were launched between 2016 and 2020,[66] the financial services sector was in the middle of rapid changes brought on by emerging technologies and business models, such as blockchain technologies, cryptocurrencies, digital and mobile banking, and peer-to-peer and crowd-lending platforms.[67] In this context, fintech sandboxes helped regulators like the Financial Conduct Authority, the Monetary Authority of Singapore, and the Hong Kong Monetary Authority better understand these technologies and attract innovative start-ups and financial firms while maintaining an innovation-friendly regulatory environment.[68] The arguments for creating AI sandboxes are perhaps stronger as many jurisdictions worldwide are now faced with the challenge of developing their regulatory approaches to artificial intelligence.

Some policymakers and popular observers in the United States might argue that the United States is falling behind its international competitors and point to the EU's Artificial Intelligence Act, reportedly the world's first comprehensive AI legislation, supposedly necessitating a similarly comprehensive legal framework that would regulate AI applications across all sectors of the U.S. economy.[69] However, this line of argumentation suffers from several shortcomings. First, it incorrectly equates the creation of comprehensive AI legislation with a country's overall competitive position in the global AI landscape. It is one thing to pass AI legislation but quite another to be a world leader in AI innovation. Second, and more importantly, it presupposes a certain uniformity of legal traditions and assumes that all jurisdictions have identical legal approaches to emerging technologies and similar timelines where statutory interventions are desired. The European Union's deliberate and careful negotiations and development of rules in different areas of AI governance—many of which would ultimately be decided through regulators and court decisions in Common Law jurisdictions—is a key feature of the continent's Civil Law traditions. The EU's approach to AI underlies several regulatory challenges—such as the classification of potentially less risky AI systems as high risk—that could lead to overregulation and stifle innovation

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66 *See* Appaya et al., *supra* note 6, at 7, fig. 2.3 & appendix 3.

67 *See generally Crowdfunding*, FIN. CONDUCT AUTH. (2016), https://www.fca.org.uk/consumers/crowdfunding; *FCA confirms new rules for P2P platforms*, FIN. CONDUCT AUTH. (2019), https://www.fca.org.uk/news/press-releases/fca-confirms-new-rules-p2p-platforms.

68 *See generally* Appaya et al., *supra* note 6; Nabil, COMPETITIVE ENTER. INST., *supra* note 2.

69 European Parliament, Press Release IPR 19015, Artificial Intelligence Act: MEPs adopt landmark law (Mar. 13, 2024), https://www.europarl.europa.eu/news/en/press-room/20240308IPR19015/artificial-intelligence-act-meps-adopt-landmark-law; Kelvin Chan, *The E.U. Has Passed the World's First Comprehensive AI Law*, TIME, Mar. 13, 2024, https://time.com/6903563/eu-ai-act-law-aritificial-intelligence-passes/.

in certain areas, although many such challenges could still be addressed within its current legal framework for AI.[70]

Nevertheless, as calls for comprehensive AI legislation grow in the United States and elsewhere, regulatory sandboxes could serve as an important tool in shaping a more careful, iterative approach to AI regulation. Through sandboxes, decision-makers in Common Law jurisdictions such as the United States and the UK can develop a more practical understanding of how AI is applied across different industries and identify any potential regulatory gaps that might require statutory interventions.[71] Instead of enacting passing comprehensive AI legislation, sandboxes can provide a tool for a more evidence-based, iterative way of lawmaking.[72]

These benefits also apply to Civil Law jurisdictions that have already introduced or are seeking to introduce comprehensive AI legislation. For the European Union, AI sandboxes could play an important role in evaluating the regulatory impact and effectiveness of its proposed legal framework for AI. However, for this approach to be effective, European policymakers must improve the mechanisms for evaluating sandbox data and regulatory lessons from national-level AI sandboxes. Such mechanisms can help European lawmakers and regulators identify any potential issues with the EU's current regulatory approach and determine whether specific regulations should be adjusted, removed, or introduced.

III. AI REGULATORY SANDBOXES IN SELECTED JURISDICTIONS

While AI sandboxes provide an opportunity to develop well-calibrated rules and promote innovation, designing such programs remains a major regulatory challenge. A notable positive development, however, is that a growing number of jurisdictions are in the process of establishing AI sandboxes. Analyzing the regulatory designs of such programs and monitoring regulatory trends in these jurisdictions can offer helpful insights and best practices for creating effective AI sandboxes. This section provides an overview of the AI sandbox strategies of jurisdictions that are at the forefront of establishing AI regulatory sandboxes as of January 2024, highlighting the potential challenges that they face in designing these sandboxes.[73]

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70 Artificial Intelligence Act, art. 6, EUR. PARL. DOC. TA 138 (2024).

71 Ryan Nabil, *Developing a Flexible, Innovation-Focused U.S. Approach to AI Regulation*, NAT'L TAXPAYERS UNION FOUND. (July 7, 2023), https://www.ntu.org/library/doclib/2023/07/Ryan-Nabil-NTUF-AI-Governance-OSTP-TECH-2023-0007-.pdf.

72 *Id.*

73 As of January 2024, these jurisdictions are the United Kingdom, the European Union, Switzerland, Norway, and, to a lesser extent, Singapore, which has developed a narrower and more sandbox for generative AI evaluation. As of March 2024, Singapore has also announced a sandbox for SMEs, although it remains unclear whether the proposed sandbox will qualify as a "regulatory sandbox." For more information, see the discussion on Singapore in this section.

As with fintech sandboxes, there appears to be greater interest in creating AI sandboxes in foreign jurisdictions, particularly in the European context. The United Kingdom, a pioneer in launching fintech sandboxes, has announced that sandboxes will play an important role in its regulatory approach to AI.[74] Meanwhile, the European Union has taken a significant interest in creating AI sandboxes. According to the EU's AI Act, which received approval from the European Parliament in March 2024 but is yet to become law, every EU Member State will be required to create at least one AI sandbox at the national level,[75] while they can also create or join additional sandboxes at the national or regional level.[76] This section also discusses AI sandboxes in Norway and Switzerland—both of which formally remain outside the European Union despite maintaining close institutional ties with the European Union. Norway is part of both the European Economic Area (EEA) and the European Free Trade Area (EFTA), while Switzerland is a member of the EFTA but not EEA.[77]

Beyond Europe, several jurisdictions have expressed interest in creating AI sandboxes. Singapore has launched an AI sandbox with the participation of ten of the world's leading AI companies,[78] while Chile and Colombia are currently exploring plans to create AI sandboxes.[79] Among the BRICS and other emerging-market nations, Brazil is currently exploring plans to create an AI sandbox,[80] while Singapore has already launched a generative AI

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74 U.K. DEP'T FOR SCI., *supra* note 17, at ¶ 95.

75 Unless otherwise noted, the European Union's Artificial Intelligence Act, as cited in this Article, refers to the final text of the AI Act as adopted by the European Parliament on March 13, 2024. Note that the Council of the European Union will formally need to endorse the final text. The legislation will enter into force 20 days after the legislation is published in the *Official Journal of the European Union*, followed by a transition period of six to 36 months, depending on the type of AI system. Artificial Intelligence Act, art. 57(1), EUR. PARL. DOC. TA 138 (2024), https://www.europarl.europa.eu/doceo/document/TA-9-2024-0138_EN.pdf. *See also* European Parliament, Press Release IPR 19015, Artificial Intelligence Act: MEPs adopt landmark law (Mar. 13, 2024).

76 Artificial Intelligence Act, art. 57(2), EUR. PARL. DOC. TA 138 (2024)

77 The EFTA consists of four countries: Iceland, Liechtenstein, Norway, and Switzerland. The EEA includes all EU Member States along with three of the EFTA members—namely, Iceland, Liechtenstein, and Norway—except for Switzerland.

78 Press Release, First of its Kind Generative AI Evaluation Sandbox for Trusted AI by AI Verify Foundation and IMDA, Infocomm Media Dev. Auth., (Oct. 31, 2023), https://www.imda.gov.sg/resources/press-releases-factsheets-and-speeches/press-releases/2023/generative-ai-evaluation-sandbox.

79 *Sandbox on privacy by design and by default in Artificial Intelligence projects*, SUPERINTENDENCIA DE INDUSTRIA Y COMERCIO [SUPERINTENDENCE OF INDUSTRY AND COMMERCE] (2021), https://www.sic.gov.co/sites/default/files/files/2021/150421%20Sandbox%20on%20privacy%20by%20design%20and%20by%20default%20in%20AI%20projects.pdf; *see also Sandbox Regulatorio de Inteligencia Artificial en Chile [Regulatory Sandbox of Artificial Intelligence in Chile]*, MINISTERIO DE ECONOMÍA, FOMENTO Y TURISMO [MINISTRY OF ECON., DEV. AND TOURISM] (2021), https://www.economia.gob.cl/wp-content/uploads/2021/09/PaperSandboxIA.pdf.

80 *Ministry of Justice and Public Security, ANPD's Call for Contributions to the regulatory sandbox for artificial intelligence and data protection in Brazil is now open*, GOV'T OF BRAZIL (2023),

evaluation sandbox with the participation of several of the world's leading AI companies.[81] While the governments of China, Russia, and India have previously created fintech sandboxes, their plans to design AI sandboxes remain unclear. While this section primarily draws from European regulatory experiences, it also briefly discusses sandboxes in select emerging-market countries in the interest of a more internationally oriented and globally aware approach to AI regulation.

A. *The United Kingdom*

As the UK government develops its regulatory regime for AI, it seeks to build upon its expertise in fintech sandboxes and establish regulatory sandboxes for AI.[82] The UK government's AI White Paper, which details the UK's approach to AI regulation, notes that the FCA's sandbox advised more than 800 companies, accelerating their entry into the market by approximately 40 percent.[83] More recently, the Medicine and Healthcare Regulatory Authority (MHRA) has announced the creation of the "AI-Airlock" sandbox to test new medical products and services.[84] While the specific details of the UK's AI sandboxes are forthcoming, the government's AI White Paper and the accompanying government consultation provide a window into its evolving sandbox strategy.

The UK's broader approach to AI regulation provides a useful starting point for understanding its evolving sandbox strategy. In an effort to position itself as a major AI hub, the UK government has put forward policies that sometimes mark a stark contrast with the European Union's regulatory approach.[85] For instance, unlike the European Union, the UK government does not currently intend to create comprehensive AI legislation.[86] Instead, the UK

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https://www.gov.br/anpd/pt-br/assuntos/noticias/anpds-call-for-contributions-to-the-regulatory-sandbox-for-artificial-intelligence-and-data-protection-in-brazil-is-now-open.

81 The participants are: Anthropic, DataRobot, Deloitte, EY, Global Regulation Inc, Google, IBM, Microsoft, NVIDIA, OCBC, Resaro.AI, Stability.AI, Singtel, TÜV SÜD, and X0PA.AI. *See* Infocomm, *supra* note 78, at Annex A – List of Participants in Sandbox.

82 U.K. DEP'T FOR SCI., *supra* note 17, at ¶¶ 94–95.

83 *Id.* at ¶ 94.

84 MEDICINES AND HEALTHCARE PRODUCTS REGULATORY AGENCY, MHRA TO LAUNCH THE AI-AIRLOCK, A NEW REGULATORY SANDBOX FOR AI DEVELOPERS (2023), https://www.gov.uk/government/news/mhra-to-launch-the-ai-airlock-a-new-regulatory-sandbox-for-ai-developers.

85 U.K. DEP'T FOR SCI., *supra* note 17; U.K. GOV'T, National AI Strategy (Sept. 2021), https://www.gov.uk/government/publications/national-ai-strategy.

86 *See* Ministerial Foreword by Rt Hon Michelle Donelan MP in the UK Government's AI White Paper: "Our approach relies on collaboration between government, regulators, and business. Initially, we do not intend to introduce new legislation. By rushing to legislate too early, we would risk placing undue burdens on businesses. But alongside empowering regulators to take a lead, we are also setting expectations. Our new monitoring functions will provide a real time assessment of how the regulatory framework is performing so that we can be confident that it is proportionate. The pace of technological development

favors an outcomes-based and sectoral, context-specific approach to AI governance, noting that the sectoral framework will be updated as needed as AI-related safety risks, regulatory challenges, and statutory gaps become evident.[87] In this context, the UK government has also developed a series of policy tools, such as a cross-sectoral risk assessment framework, to support the implementation of the government's broader approach to AI regulation.[88]

Furthermore, whereas the European risk-rated regulatory approach focuses on classifying different types of AI systems according to their risk level, the UK approach emphasizes the *context-specific* nature of AI risks.[89] For example, AI applications in the nuclear sector would generally be associated with a much higher level of risk than spam filters in emails.[90] However, even within the nuclear sector, not all potential AI applications would carry the same risks, and the UK approach seeks to recognize such differences.[91] For instance, whereas using AI to improve the process of nuclear fusion would carry significant risks, using AI to identify minor cosmetic flaws within a nuclear plant would involve much lower risks.[92] The sector- and context-specific nature of AI applications means that regulatory supervision of an AI sandbox will require deep regulatory knowledge of the specific sector(s) and any associated artificial intelligence and data protection law that might apply.[93]

The UK's sandbox strategy builds upon this sector- and context-approach to AI, which raises important questions regarding regulatory design. Should the UK's AI sandbox program(s) cover single or multiple sectors and implicate the jurisdiction of one or multiple regulators?[94] The response involves four possible combinations: i) single-sector sandbox with a single regulator; ii) multi-sector sandbox with a single regulator; iii) single-sector sandbox with multiple regulators; and iv) multi-sector sandbox with multiple regulators.[95]

As a first step, the UK government plans to roll out a pilot AI sandbox that focuses on only one sector, which will be under the regulatory

also means that we need to understand new and emerging risks, engaging with experts to ensure we take action where necessary. A critical component of this activity will be engaging with the public to understand their expectations, raising awareness of the potential of AI and demonstrating that we are responding to concerns." U.K. DEP'T FOR SCI., *supra* note 17.

87 *Id*.

88 *Id.*

89 *See generally* Lilian Edwards, *Expert explainer: The EU AI Act proposal*, ADA LOVELACE INST. (Apr. 8, 2022), https://www.adalovelaceinstitute.org/resource/eu-ai-act-explainer/; *see* U.K. DEP'T FOR SCI., *supra* note 17, at ¶ 96.

90 U.K. DEP'T FOR SCI., *supra* note 17; *see also* Nabil, YALE J. INT'L AFFS., *supra* note 61, at 4.

91 Nabil, YALE J. INT'L AFFS., *supra* note 61, at 4.

92 *Id.*

93 U.K. DEP'T FOR SCI., *supra* note 17.

94 *Id.* ¶ 96.

95 *Id*.

supervision of multiple regulators, corresponding to the third model in Table 1.[96] However, recognizing that generative AI and other AI applications and systems often cut across different sectors, this pilot sandbox would be expanded to cover multiple sectors.[97] Since such an arrangement would involve multiple sectors and require the participation of multiple regulators, it would correspond to the fourth model in Table 1.[98]

Table 1. Possible Models for the UK's Proposed Artificial Intelligence Sandbox Program(s)[99]

Model	Description
i) Single sector, single regulator	"[S]upport innovators to bring AI products to the market in collaboration with a single regulator, focusing on only one chosen industry sector."
ii) Multiple sectors, single regulator	[S]support AI innovators in collaboration with a single regulator that is capable of working across multiple industry sectors."
iii) Single sector, multiple regulator	"[E]stablish a sandbox that only operates in one industry sector but is capable of supporting AI innovators whose path to market requires interaction with one or more regulators operating in that sector."
iv) Multiple sectors, multiple regulators	"[A] sandbox capable of operating with one or more regulators in one or more industry sectors to help AI innovators reach their target market. The DRCF [Digital Regulation Cooperation Forum] is piloting a version of this model."

While designing sector-specific sandboxes—whether single or multiple regulators—the question arises regarding the sectors in which such sandboxes should be introduced. The UK government's current position is that the pilot sandbox will be focused on "a sector where there is a high degree of AI investment, industry demand for a sandbox, and appetite for improved collaboration between regulators to help AI innovators take their products to market."[100] This approach is a helpful starting point, especially given that the government recently solicited public and expert input on this issue through a consultation.[101]

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96 *Id.* ¶ 97.

97 *Id.*

98 U.K. DEP'T FOR SCI., *supra* note 17, at ¶ 97.

99 *Id.*

100 *Id.* at ¶ 98.

101 U.K. DEP'T FOR SCI., INNOVATION & TECH., & UK OFF. FOR A.I., *A pro-innovation approach to AI regulation: Government Response*, at Annex C, Questions S1 to S3 (Feb. 6, 2024), https://www.gov.uk/government/consultations/ai-regulation-a-pro-innovation-approach-policy-

Nevertheless, additional questions remain. For example, what will regulatory coordination mechanisms in a sandbox involving multiple sectors and regulators look like? As the White Paper notes,[102] the Digital Regulation Cooperation Forum (DRCF)—a network of regulators involving the Competition and Markets Authority, the Information Commissioner's Office, the Office of Communications, and the Financial Conduct Authority—is currently piloting a version of this model.[103] However, in some contexts, a larger platform with more stakeholders or a platform with a different set of stakeholders might be more appropriate. For example, the Department of Transportation's involvement would likely be essential in a hypothetical AI sandbox focusing on autonomous vehicles. Additionally, whether such cooperation is best conducted through informal arrangements like the DRCF or whether an appropriate statutory basis should be established through legislation remains to be seen. Ultimately, answering these questions will likely require some regulatory experimentation and involve a process of trial and error. However, considering these questions can help the UK government design more effective AI sandboxes, which can play a useful role in implementing the government's AI framework.

B. *The European Union*

Across the Channel, the European Commission, the executive arm of the European Union, first proposed the creation of regulatory sandboxes in the draft of the Artificial Intelligence Act in April 2021,[104] and Spain became the first EU country last year to have launched an AI sandbox.[105] Although the European Union had initially expressed a lukewarm attitude towards regulatory sandboxes, the EU increasingly appears to endorse AI sandboxes as a tool to promote innovation.[106] While the EU's approach to AI is still evolving, the final AI Act text provides helpful insights into recent European thinking on AI sandboxes. First, whereas the first draft of the AI Act only

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proposals/outcome/a-pro-innovation-approach-to-ai-regulation-government-response#annex-c-individual-question-summaries.

102 *The Digital Regulation Cooperation Forum*, U.K. GOV'T, https://www.gov.uk/government/collections/the-digital-regulation-cooperation-forum (last visited Jan. 29, 2023).

103 U.K. DEP'T FOR SCI., *supra* note 17, at ¶ 96.

104 *Proposal for a Regulation of the European Parliament and of the Council Laying Down Harmonised Rules on Artificial Intelligence (Artificial Intelligence Act) and Amending Certain Union Legislative Acts*, art. 53(1), COM (2021) 206 final (April 4, 2021), https://artificialintelligenceact.eu/wp-content/uploads/2022/05/AIA-COM-Proposal-21-April-21.pdf [hereinafter EU AI Act Proposal].

105 ROYAL DECREE 817/2023, *supra* note 28.

106 Ryan Nabil, *Reforming the European Union's Proposed AI Regulatory Sandbox*, AUSTL. INST. INT'L AFFS. (Oct. 6, 2023), https://www.internationalaffairs.org.au/australianoutlook/reforming-the-european-unions-proposed-ai-regulatory-sandbox; Artificial Intelligence Act, art. 57, EUR. PARL. DOC. TA 138 (2024).

recommended that individual EU countries create a regulatory sandbox program,[107] the final AI Act text requires that every EU Member State create at least one AI sandbox at the national level (although this requirement could also be fulfilled by joining an existing AI sandbox).[108] In addition, the European Data Protection Supervisor might also create AI sandboxes at the EU level, the details of which might be provided in future implementing acts.[109]

Second, another issue with the EU's original sandbox proposal was that innovation did not appear to be a priority of the European AI strategy.[110] However, the final text appears to make supporting innovation a more important aspect of the AI Act more generally and regulatory sandboxes more specifically.[111] Although the EU's AI approach still has significant scope for improvement, the increased emphasis on innovation is a step in the right direction.[112] Third, the AI Act rightly recognizes the importance of regulatory learning and how regulatory insights gained through AI sandboxes could help calibrate the EU's AI framework.[113]

Fourth, the AI Act also recognizes potential challenges that could arise from an AI sandbox and rightly emphasizes the importance of informed consent and adequate data protection standards during the sandbox testing period.[114] Fifth, the legislation grants Member States significant autonomy in designing AI sandboxes at the national level. While this flexibility is a step in the right direction, the EU must address significant challenges of regulatory coordination, such as how sandboxes are designed and implemented in various Member States. To that end, the European Commission has proposed several mechanisms, including the creation of the Artificial Intelligence Board, which, among others, will also provide support and advice to national

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107 EU AI Act Proposal (Apr. 21, 2021), art. 53(1).

108 Artificial Intelligence Act, art. 57(1), EUR. PARL. DOC. TA 138 (2024).

109 *Id.* at art. 57(3).

110 Nabil, AUSTL. INST., *supra* note 106.

111 Artificial Intelligence Act, recital (1), art. 57(5), EUR. PARL. DOC. TA 138 (2024).

112 KI Bundesverband [German AI Association], Statement des KI Bundesverband zur aktuellen Dynamik um den AI Act [Statement of the German AI Association on the Current Dynamic of the AI Act] (2024).

113 More specifically, Recital (139) of the AI Act states: "The objectives of the AI regulatory sandboxes should be to foster AI innovation by establishing a controlled experimentation and testing environment in the development and pre-marketing phase with a view to ensuring compliance of the innovative AI systems with this Regulation and other relevant Union and national law, to enhance legal certainty for innovators and the competent authorities' oversight and understanding of the opportunities, emerging risks and the impacts of AI use, to facilitate regulatory learning for authorities and undertakings, including with a view to future adaptions of the legal framework, to support cooperation and the sharing of best practices with the authorities involved in the AI regulatory sandbox, and to accelerate access to markets, including by removing barriers for SMEs, including start-ups (emphasis removed)." Artificial Intelligence Act, recital (139), EUR. PARL. DOC. TA 138 (2024).

114 Artificial Intelligence Act, arts. 57-58, EUR. PARL. DOC. TA 138 (2024).

authorities for establishing and operating sandboxes.[115] While the effectiveness of such measures remains to be seen, the EU is right to recognize the importance of regulatory coordination and the need for a more harmonized approach for EU-aligned AI sandboxes at the national level.[116]

Finally, the AI Act recognizes that its obligations could disproportionately impact SMEs and emphasizes the importance of removing regulatory barriers for smaller businesses through AI sandboxes.[117] While the European approach to AI governance could still benefit from improvements in other areas, the revised approach to AI sandboxes is a step in the right direction.

C. *Selected EU, EEA, and EFTA Member States*

Currently, individual EU countries are given significant autonomy in creating and implementing such sandboxes within the framework of the EU's broader AI sandbox policy. While the EU will likely create additional common rules for implementing EU-aligned AI sandboxes at the national level, there could still be considerable divergences in how different EU countries design AI sandboxes.[118] For example, whereas some countries might launch several AI sandboxes, smaller jurisdictions might instead join existing sandboxes offered by other EU countries. As more Member States develop EU-aligned sandboxes at the national level, analyzing the differences in regulatory designs between different EU countries will become especially important.

1. Spain

Spain deserves particular mention among EU Member Countries in its efforts to create an AI regulatory sandbox. It became the first EU country to announce the creation of an AI sandbox in June 2022.[119] After receiving

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[115] *Artificial Intelligence in the European Commission*, EUR. COMM'N, (2024), https://commission.europa.eu/system/files/2024-01/EN%20Artificial%20Intelligence%20in%20the%20European%20Commission.PDF.

[116] *Id.*; Artificial Intelligence Act, arts. 58(1)–(2), EUR. PARL. DOC. TA 138 (2024).

[117] For example, the AI Act states: "Regulatory sandboxes should be widely available throughout the Union, and particular attention should be given to their accessibility for SMEs, including start-ups. The participation in the AI regulatory sandbox should focus on issues that raise legal uncertainty for providers and prospective providers to innovate, experiment with AI in the Union and contribute to evidence-based regulatory learning. . . ." Artificial Intelligence Act, recital (139), EUR. PARL. DOC. TA 138 (2024).

[118] Artificial Intelligence Act, arts. 58(1)–(2), EUR. PARL. DOC. TA 138 (2024).

[119] *Launch event for the Spanish Regulatory Sandbox on Artificial Intelligence*, EUR. COMM'N (2022), https://digital-strategy.ec.europa.eu/en/events/launch-event-spanish-regulatory-sandbox-artificial-intelligence.

Royal assent from King Felipe VI, the Spanish Decree 817/2023 provided the legal basis for the first EU-aligned AI sandbox, creating a space for public and private entities to test AI-enabled products and services.[120] The Spanish government also created the *Agencia Española de Supervisión de la Inteligencia Artificial* (AESIA or the "Spanish Agency for the Supervision of Artificial Intelligence" in English], reportedly the first body of its kind in the EU.[121] The AESIA is expected to enforce the legal provisions of the EU's AI Act in Spain and collaborate with the Spanish Data Protection Authority in cases where AI Act responsibilities overlap with GDPR requirements.[122] However, in cases of overlapping jurisdiction in areas such as financial services and healthcare, the extent to which it can successfully coordinate with other Spanish regulators remains to be seen and could influence the program's effectiveness. Other challenges related to the broader EU's AI sandbox strategy, such as regulatory coordination between the EU and Member States and the extent to which regulatory insights are used as a basis for policy reform, also apply to the Spanish sandbox. How the Spanish and European governments and EU institutions respond to these challenges will be key in determining the future success of European AI sandboxes.

2. Germany

There has been growing interest in creating AI sandboxes in Germany, the EU's economic powerhouse. Although Germany's Federal Ministry for Economic Affairs and Climate Action (*Bundesministerium für Wirtschaft und Klimaschutz* or BMWK) launched a sandbox for green energy technologies, the German government has not yet launched an AI sandbox at the national level.[123] However, the German AI strategy recognizes the importance of regulatory sandboxes for developing appropriate legal frameworks and promoting innovation,[124] while BMWK has also issued a more detailed

120 ROYAL DECREE 817/2023, *supra* note 28.

121 *El Gobierno inicia el proceso para elegir la sede de la Agencia Española de Supervisión de la Inteligencia Artificial [The Government starts the process to choose the headquarters of the Spanish Agency for Artificial Intelligence Supervision]*, MINISTERIO DE ASUNTOS ECONÓMICOS Y TRANSFORMACIÓN DIGITAL [MINISTRY OF ECONOMIC AFFAIRS AND TRANSFORMATION] (2022), https://portal.mineco.gob.es/RecursosNoticia/mineco/prensa/noticias/2022/20220913_ndp_sede_agencia_ia.pdf.

122 *Id*.

123 *Was passiert eigentlich in einem Reallabor der Energiewende? [What actually happens in a real-life laboratory for the energy transition?]*, BUNDESMINISTERIUM FÜR WIRTSCHAFT UND KLIMASCHUTZ [FEDERAL MINISTRY FOR ECONOMIC AFFAIRS AND CLIMATE ACTION OF GERMANY] (2021), https://www.bmwk-energiewende.de/EWD/Redaktion/Newsletter/2021/05/Meldung/direkt-erklaert.html.

124 *Strategie Künstliche Intelligenz der Bundesregierung [Artificial Intelligence Strategy of the Federal Government]*, DIE BUNDESREGIERUNGINISTERIO [THE FEDERAL GOVERNMENT] (2020) at 21–22, https://www.ki-strategie-deutschland.de/files/downloads/201201_Fortschreibung_KI-Strategie.pdf.

strategy and advisory document about developing experimental clauses ("Experimentierklause") and regulatory sandboxes ("Reallabor").[125] Having been published in 2020, a year before the publication of the EU's first AI Act draft, these documents do not reflect the same alignment with the AI Act as the Spanish government's AI strategy, although that could change in the future.[126]

3. France

In France, the country's data protection authority—known as the *Commission nationale de l'informatique et des libertés* or CNIL in short—has also emerged as an important actor in the European AI sandbox regulatory landscape.[127] CNIL has also developed a cohorts-based sandbox, where the latest sandbox cohort focused on using artificial intelligence to promote public-sector innovation.[128] It should be noted, however, that the Spanish AI sandbox is expressly aligned with the EU's AI Act via statute,[129] but that does not

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125 *Recht flexibel [Quite flexible]*, Bundesministerium für Wirtschaft und Klimaschutz [Federal Ministry for Economic Affairs and Climate Action of Germany], (2020), https://www.bmwk.de/Redaktion/DE/Publikationen/Digitale-Welt/recht-flexibel-arbeitshilfe-experimentierklauseln.html.

126 *Id.*

127 *Intelligence artificielle: l'avis de la CNIL et de ses homologues sur la future réglementation européenne [Artificial intelligence: the opinion of the CNIL and its counterparts on the future European regulation]*, COMMISSION NATIONALE DE L'INFORMATIQUE ET DES LIBERTES [NATIONAL COMMISSION ON INFORMATICS AND LIBERTY ("CNIL")] (2021), https://www.cnil.fr/en/artificial-intelligence-opinion-cnil-and-its-counterparts-future-european-regulation.

128 *Bac à sable intelligence artificielle et services publics: la CNIL accompagne 8 projets innovants [AI sandbox and Public Service: CNIL supports 8 Innovative Projects]*, CNIL (2023), https://www.cnil.fr/fr/bac-sable-intelligence-artificielle-et-services-publics-la-cnil-accompagne-8-projets-innovants.

129 *See* ROYAL DECREE 817/2023, *supra* note 28. According to the preamble to the Royal Decree 817/2023, "En este contexto, el Gobierno de España, con la colaboración de la Comisión Europea, pone en marcha el primer entorno controlado de pruebas para comprobar la forma de implementar los requisitos aplicables a los sistemas de inteligencia artificial de alto riesgo de la propuesta de reglamento europeo de inteligencia artificial con el ánimo de obtener, como resultado de esta experiencia, unas guías basadas en la evidencia y la experimentación que faciliten a las entidades, especialmente las pequeñas y medianas empresas, y a la sociedad en general, el alineamiento con la propuesta del Reglamento Europeo de Inteligencia Artificial. Durante el desarrollo de este entorno controlado de pruebas, se utilizará como referencia la posición del Consejo de la Unión Europea del 25de noviembre de 2022, como se explica en el anexo I." Author's translation: "In this context, the Government of Spain, in collaboration with the European Commission, launches the first controlled environment to test ways to implement the requirements applicable to high-risk AI systems of the proposed European regulation on artificial intelligence with the aim of obtaining, based on this experience, evidence-based guidelines and feedback that will facilitate the alignment with the proposed European regulation on artificial intelligence, evidence-based guidelines and experimentation that will facilitate the alignment of entities, especially small and medium-sized entities, and businesses in general, with the proposal of the European regulation on artificial intelligence. During

appear to be the case for the CNIL sandbox, which became operational in February 2021.[130] Unlike many regulatory sandboxes in the United Kingdom and the United States, the CNIL sandbox does not focus on promoting innovation directly by providing regulatory relief or by suspending existing legal requirements.[131] Instead, it focuses on helping participants achieve regulatory compliance with data protection regulations, particularly the GDPR, in the context of AI-enabled products and services.[132] Like the Spanish model and the broader EU's approach to AI sandbox, the CNIL approach focuses on compliance rather than experimentation.[133] This approach reflects the more cautious European approach to regulatory sandboxes—although that could change in light of the EU's growing support for AI sandboxes and technological innovation more broadly.

One interesting aspect of CNIL's sandbox strategy is its adoption of thematic sandboxes and a cohorts-based model, which remains relatively unusual in the United States.[134] More specifically, the CNIL sandbox is "thematic" in the sense that different iterations of the sandbox focus on particular issues. For example, whereas the first two editions of the sandbox focused on digital health and educational technology, the most recent iteration focuses on AI applications in the public sector.[135] The CNIL sandbox also uses a cohorts-based model instead of an open-application model, meaning that companies apply to the sandbox and are admitted during a given time period.[136] In the U.S. context, an imperfect analogy would be Hawaii's Digital Currency Innovation Lab sandbox, which is also i) thematic (aimed at digital currencies) and ii) cohorts-based (albeit with only one cohort with

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the development of this evidence-controlled environment, the position of the Council of the European Union as of 25 November 2022, as explained in Annex I, will be used as a reference."

130 *Bac à sable » données personnelles de la CNIL : appel à projets 2021 [CNIL's personal data 'sandbox': call for projects 2021]*, CNIL (2021), https://www.cnil.fr/fr/bac-a-sable-2021.

131 *See, e.g.*, *Bac à sable « santé numérique »: Les recommandations de la CNIL aux lauréats [Digital Health Sandbox: CNIL's recommendations to graduates]*, CNIL (2023) https://www.cnil.fr/sites/cnil/files/2023-07/bilan_bac_a_sable_sante_numerique.pdf; *see also Bac à sable « EdTech »: Les recommandations de la CNIL aux lauréats, ["EdTech" sandbox: CNIL's recommendations to the sandbox graduates]*, CNIL (2023), https://www.cnil.fr/sites/cnil/files/2023-07/bilan_bac_a_sable_edtech.pdf.

132 *Digital Health Sandbox*, CNIL, *supra* note 131; *"EdTech" Sandbox*, CNIL, *supra* note 131.

133 *Digital Health Sandbox*, CNIL, *supra* note 131; *"EdTech" Sandbox*, CNIL, *supra* note 131.

134 *Digital Health Sandbox*, CNIL, *supra* note 131; *"EdTech" Sandbox*, CNIL, *supra* note 131.

135 *« Bac À sable » données personnelles : la CNIL lance un appel à projets sur l'intelligence artificielle dans les services publics [Personal data « sandbox »: CNIL launches a call for projects on artificial intelligence in public services]*, GOV'T OF FRANCE (2023), https://www.bercynumerique.finances.gouv.fr/bac-sable-donnees-personnelles-la-cnil-lance-un-appel-projets-sur-lintelligence-artificielle-dans.

136 *Id.*

subsequent additions and a testing period of approximately 51 months after an extension instead of six months as is the case with the CNIL sandbox).[137]

4. Norway

Beyond the European Union, Norway and Switzerland are also becoming increasingly active in the AI regulatory sandbox landscape. While Norway is not part of the European Union, it remains part of the EEA and the EFTA, and Oslo's regulatory approach to AI appears broadly aligned with the EU's, as reflected in the Norwegian position paper on the EU's AI Act.[138] The Norwegian government has also expressed interest in creating regulatory sandboxes to promote AI innovation, as detailed in its national AI strategy.[139] Like the UK government, the Norwegian government also recognizes that AI applications vary significantly depending on the function and argues that multiple sandboxes will be more appropriate than a single AI sandbox. As noted in the Norwegian national AI strategy:

> However, it makes little sense to talk about one regulatory sandbox for AI. AI solutions do not represent a homogeneous group of services and are subject to a broad spectrum of regulations and regulatory authorities, depending on their purpose and functionality.[140]

This approach builds on the Norwegian government's willingness to create several regulatory sandboxes in recent years. Finanstilsynet, the country's financial supervisory authority, created a fintech sandbox in December 2019, while a similar sandbox was also created for autonomous vehicles in 2016.[141] More recently, Datatilsynet, Norway's data protection regulator, launched an AI-focused sandbox that has already seen a number of participants since January 2022.[142] More specifically, the sandbox provides

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[137] Unlike the CNIL sandbox, the Hawaii DCIL sandbox is expected to expire after the testing period ends. *See* HAW. DEP'T COM. AND CONSUMER AFFS., *State of Hawai'i's Digital Currency Innovation Lab Extended to June 30, 2024*, (June 2, 2022), https://cca.hawaii.gov/dfi/files/2022/06/06-02-22-DCIL-Extension-Press-Reease-FINAL.pdf.

[138] *Norwegian Position Paper on the European Commission's Proposal for a Regulation of the European Parliament and of the Council Laying Down Harmonised Rules on Artificial Intelligence (Artificial Intelligence Act) and Amending Certain Union Legislative Acts*, GOV'T OF NORWAY (2021), https://www.regjeringen.no/contentassets/939c260c81234eae96b6a1a0fd32b6de/norwegian-position-paper-on-the-ecs-proposal-for-a-regulation-of-ai.pdf.

[139] *National Strategy for Artificial Intelligence*, NORWEGIAN MINISTRY OF LOCAL GOV'T AND MODERNISATION 24 (2020), https://www.regjeringen.no/contentassets/1febbbb2c4fd4b7d92c67ddd 353b 6ae 8/en-gb/pdfs/ ki-strategi_en.pdf.

[140] *Id.*

[141] *Id.*

[142] *Reports*, DATATILSYNET, https://www.datatilsynet.no/en/regulations-and-tools/sandbox-for-artificial-intelligence/reports/ (last visited Mar. 29, 2024).

regulatory advice regarding the data protection requirements and privacy implications associated with AI-enabled products and services.[143] As part of the sandbox program, Datatilsynet also seeks to create a collaborative learning environment for participating companies and communicate regulatory insights to other companies and policymakers—features that distinguish the Datatilsynet sandbox from several of its foreign counterparts.[144] Beyond helping companies, the sandbox has helped improve Datatilsynet's own legal understanding of the field, as noted in its assessment report.[145]

This sandbox, of course, has scope for improvement. As the case with the French CNIL sandbox and Spanish AI sandboxes, the Norwegian sandbox remains limited in its ability to provide regulatory relief and calibrate regulations. Norway might also benefit from other AI-related sandboxes in other sectors beyond the direct jurisdiction of the data protection authority. Nevertheless, Norway's thoughtful approach to creating AI sandboxes and its success in attracting quality applicants and communicating the results of its sandbox experiences makes the country a worthwhile case study for other jurisdictions seeking to launch AI sandboxes, especially within the framework of the EU and EEA.

5. Switzerland (Canton of Zurich)

Finally, Switzerland, which belongs to the EFTA but neither the EU nor the EEA, has also become active in the regulatory sandbox landscape. Previously, the Swiss Financial Market Supervisory Authority was one of the first continental regulators to create a fintech sandbox.[146] More recently, Zurich Canton has launched several thematic programs within the framework of the broader "Innovation Sandbox for Artificial Intelligence."[147] This sandbox is the result of collaboration among several Swiss government bodies, universities, and industry associations to promote AI-enable innovation in targeted areas.[148] Thus far, the thematic iterations of the Zurich sandbox have focused

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143 Markussen, *Evaluation of Norwegian Data*, *supra* note 20, at 17.

144 *Id* at 40–42.

145 *Id* at 40.

146 SWISS FIN. MKT. SUPERVISORY AUTH., *Die FINMA ist fit für Fintech* [FINMA is fit for fintech], (Sept. 13, 2016), https://www.finma.ch/de/~/media/finma/dokumente/dokumentencenter/myfinma/finma-publikationen/referate-und-artikel/20160913-fit-fuer-fintech-le-temps_de.pdf.

147 ZURICH CANTON, *supra* note 16.

148 More specifically, the participating entities are: i) Location Promotion in the Office for Economy, Canton of Zurich; ii) Office for Economy and Labor, Canton of Schwyz; iii) Statistical Office, Canton of Zurich; iv) Digital Administration and E-Government, State Chancellery Canton of Zurich; v). Metropolitan Area Zurich; vi) ETH AI Center (Swiss Federal Institute of Technology); vii) University of Zurich Center for Information Technology, Society, and Law; viii) University of Zurich Digital Society Initiative; ix) Swiss Information and Communication Technology Association; x) Zurich University of Applied Sciences Entrepreneurship; and xi) Lucerne University of Applied Sciences and Arts. *Id.*

on five areas: i) autonomous systems; ii) automated infrastructure maintenance (drone inspection with image recognition); iii) AI in education; iv) smart parking (image recognition); and machine translation.[149]

The stated goals of the Zurich AI sandbox are to "i) provide regulatory clarity; ii) promote innovation through the provision of data; and iii) to transfer know-how and initiate new projects."[150] According to Swiss regulators, since this program provides participating companies with both regulatory support and access to new data, it qualifies as an "innovation sandbox" rather than a "regulatory sandbox."[151] In contrast, regulatory sandboxes provide regulatory support but do not include any such data provision for participating companies, according to the definition provided by Zurich Canton.[152] While this distinction between "innovation sandbox" and "regulatory sandbox" does not appear to be widely recognized by other governmental bodies and legal scholars, the Zurich sandbox's focus on promoting innovation by providing access to regulatory data is a feature that distinguishes it from other AI sandboxes discussed in this Article, which would be considered merely "regulatory sandboxes" and not "innovation sandboxes" under Zurich Canton's definition.[153]

Beyond these aspects, the Zurich sandbox features additional characteristics that distinguish it from its European counterparts. For example, it places a greater focus on understanding the regulatory implications of different emerging technologies—such as image recognition technologies in drones and their potential in automated infrastructure maintenance—and on updating laws and regulations accordingly.[154] The focus on highly specific themes, like image recognition-enabled smart parking, could allow Swiss regulators to identify regulatory challenges and fine-tune AI rules for highly specialized domains of AI applications.[155] If this approach is scaled up and successfully implemented at the national level, it could provide valuable regulatory insights for regulators across Europe and beyond.

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149 *Id.*

150 Based on the author's translation of the three goals provided in German: "i) Regulatorische Klarheit schaffen, ii) Innovationsförderung durch Datenbereitstellung, [und] iii) Know-how-Transfer und Anstoss neuer Projekte." *Id.*

151 Zurich Canton offers the following distinction between an innovation sandbox, a regulatory sandbox, and an open data sandbox: i) Innovation sandbox: with regulatory support ("Mit regulatorischer Begleitung") and with data provision ("Mit Datenbereitstellung"); ii) Regulatory sandbox: with regulatory support but without data provision; iii) Open data sandbox: with data provision but without regulatory support; iv) Without a sandbox: Without regulatory support and without data provision. *See id.* at Figure "Unterschied zwischen Regulatory Sandbox, Open Data Sandbox und Innovation Sandbox" ["Difference between Regulatory Sandbox, Open Data Sandbox, and Innovation Sandbox"].

152 Zurich Canton, supra note 16.

153 *Id.*

154 *Id.*

155 *Id.*

D. *Selected Emerging-Market Countries*

While this Article mostly draws from regulatory sandboxes in Europe and the United States, it also recognizes growing technological and policy innovations elsewhere. As was the case with the global regulatory landscape for fintech sandboxes, where Asian jurisdictions like Hong Kong and Singapore played an important role, jurisdictions outside the United States and Europe have demonstrated interest in creating AI sandboxes. While the sandbox strategies of many such countries merit more careful examination, a comprehensive discussion goes beyond the scope of this Article. However, in the interest of a more global view of AI sandboxes, this section briefly discusses noteworthy developments in selected non-Western jurisdictions. Such developments might be particularly insightful for emerging-market nations seeking to create regulatory sandboxes and promote AI innovation within the context of their specific economic and political conditions.

1. Singapore[156]

In September 2023, Singapore's Infocom Media Development Authority (IMDA) and the AI Verify Foundation, a non-profit foundation under the IMDA, launched a generative AI evaluation sandbox.[157] This sandbox is reportedly the first AI sandbox outside of Europe and the first sandbox in the world to focus on generative AI evaluation.[158] More specifically, the IMDA sandbox seeks to create a testing framework (called "AI Verify") based on five internationally recognized AI ethics principles, which future developers

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156 In February 2024, the Infocomm Media Development Authority announced a generative AI sandbox for small and medium-sized enterprises, the applications for which are expected to close in May 2024. Since this sandbox was announced after the first draft of this Article was submitted, it is not included in this section. Furthermore, while information about this sandbox remains limited, the sandbox appears more focused on providing financial support to SMEs for generative AI enterprise solutions and developing the local AI ecosystem instead of providing regulatory support and relief. Therefore, it is unclear whether this sandbox fulfills the criteria of a "regulatory sandbox" as typically understood by regulators in the UK, the EU, Australia, and Canada (see the discussion *supra* note 3). That is why this sandbox most likely falls outside the scope of this study, which is restricted to "regulatory sandboxes" for AI. Nevertheless, as more information about this sandbox becomes available, legal and policy scholarship would benefit from closer attention to it and the extent to which it varies from other AI sandboxes included in this Article. *See* Infocomm, *supra* note 78; Andy Leck, *Singapore: First Generative AI Sandbox to Allow SMEs to Harness the Benefits of Generative AI*, BAKER MCKENZIE (Mar. 18, 2024), https://www.globalcompliancenews.com/2024/03/18/https-insightplus-bakermckenzie-com-bm-technology-media-telecommunications_1-singapore-first-generative-ai-sandbox-to-allow-smes-to-harness-the-benefits-of-generative-ai_02272024.

157 Infocomm, *supra* note 78; *see also What is A.I. Verify?*, AI VERIFY FOUND., https://aiverifyfoundation.sg/what-is-ai-verify/ (last visited Jan. 24, 2024).

158 *Id.*

could use to test AI systems.[159] With participation from leading global companies, the sandbox also displays a distinct international character.[160]

However, compared to most other AI sandboxes discussed in this paper, this sandbox is narrower in scope since it only seeks to develop benchmarks for evaluating the ethical compliance of AI systems. Despite its narrower scope, the sandbox is committed to solving an increasingly important global challenge of generative AI evaluation.[161] Despite the growing use of generative AI, there appears to be a lack of common benchmarks for large language models.[162] Through the sandbox, the IMDA seeks to develop a "baseline set of evaluation tests" for generative AI products that companies and regulators in Singapore and other jurisdictions can use to address this challenge.[163]

Unlike the European Union, which emphasizes the importance of SME participation in AI sandboxes,[164] the IMDA sandbox has only admitted large technology companies to its generative AI evaluation sandbox.[165] Thus far, ten leading tech companies—including Microsoft, IBM, Google, NVIDIA, and Amazon—have joined the Singapore sandbox.[166] Although the EU is right to stress the importance of admitting SMEs into its AI sandboxes,[167] the Singapore sandbox's more specific policy objectives might have required a more tailored approach.[168] Since this sandbox primarily seeks to produce specific testing guidelines and standards instead of helping companies test new products and bring them into regulatory compliance, prioritizing larger companies with extensive capabilities in large language models is understandable.[169] However, in the context of more general AI sandboxes, a mix of smaller and larger participants can help regulators better understand the impacts of various regulations on different types of and their consumers.[170] Future AI sandboxes in Singapore might also benefit from admitting and receiving input from a more heterogeneous set of firms from diverse sectors.

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159 *AI Governance Testing Framework and Toolkit*, AI VERIFY FOUND. (2023), https://aiverifyfoundation.sg/downloads/AI_Verify_Primer_Jun-2023.pdf.

160 *See* Infocomm, *supra* note 78, at Annex A – List of Participants in Sandbox.

161 Infocomm, *supra* note 78; *see also What is A.I. Verify?*, *supra* note 157.

162 Infocomm, *supra* note 78.

163 *Id.*; MINISTRY OF COMMUNICATIONS AND INFORMATION, AI FOR THE PUBLIC GOOD FOR SINGAPORE AND THE WORLD (2023), https://file.go.gov.sg/nais2023.pdf.

164 EU AI Act Recital (143), Art. 58 (2) (d), Art. 58 (2) (f).

165 *See* Infocomm, *supra* note 78, at Annex A – List of Participants in Sandbox.

166 *See* Infocomm, *supra* note 78, at Annex A – List of Participants in Sandbox.

167 EU AI Act Recital (143), Art. 58 (2) (d), Art. 58 (2) (f).

168 Infocomm, *supra* note 78; *see also What is A.I. Verify?*, *supra* note 157.

169 *See What is A.I. Verify?*, *supra* note 157.

170 Nabil, COMPETITIVE ENTER. INST., *supra* note 2, at 9–12.

2. China

The Chinese government's approach to AI governance and regulatory sandboxes is particularly important in both the Asian and the broader global contexts. As Matt Sheehan of the Carnegie Endowment for International Peace correctly points out, international observers, particularly in the United States, tend to i) dismiss China's AI laws and regulations as "irrelevant" or unworthy of rigorous scholarship or ii) instrumentalize such laws as political props to the benefit of normative political arguments.[171] One consequence of this approach is that China's approach to AI governance is poorly understood in most Western countries.[172] While a detailed analysis of the Chinese approach to regulatory sandboxes and AI governance is an important topic that goes beyond the scope of this paper, a discussion of the global regulatory landscape of AI sandboxes would be incomplete without at least briefly mentioning Chinese regulatory sandboxes.

Despite Chinese Premier Xi Jinping's recent efforts to centralize power and increase party control over private companies, many aspects of Chinese technology governance remain decentralized in important ways, with at least some Chinese technology-related initiatives and regulations being implemented at the provincial instead of national level.[173] In the context of financial regulation, the Chinese government announced the creation of a financial regulatory sandbox in December 2019. Since then, the People's Bank of China and nine cities announced more than 60 projects that could be considered regulatory sandboxes.[174]

In comparison, the extent to which artificial intelligence "regulatory sandboxes," as understood in Europe and the United States, are a priority for the Party leadership and key actors of Chinese technology policy—notably the Ministry of Science and Technology (MOST), the Cyberspace Administration of China (CAC), and the Ministry of Industry and Information Technology (MIIT)—appear less clear.[175] However, the Chinese government has endeavored to create innovation zones ("国家人工智能创新应用先导区" or the "National Pilot Zone for Artificial Intelligence Innovation and Application") and AI-related projects, some of which might share specific features

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171 For a broader discussion, *see* Matt Sheehan, *China's AI Regulations and How They Get Made*, CARNEGIE ENDOWMENT FOR INT'L PEACE at 7 (July 2023), https://carnegieendowment.org/2023/07/10/china-s-ai-regulations-and-how-they-get-made-pub-90117.

172 *Id.*

173 *Id.*

174 Mi Wang, *Regulation Paths of Regulatory Sandbox Entry Mechanism in China*, INT'L J.L. & SOC'Y (Dec. 27, 2022), https://www.sciencepublishinggroup.com/article/10.11648.j.ijls.20220504.17.

175 Sheehan, *supra* note 171, at 22–24.

of regulatory sandboxes.[176] Since the MOST announced the creation of the country's first five innovation zones in February 2021, there have been 11 such zones with 100 innovation projects, according to the International Center for Science and Technology Innovation (ICSTI), affiliated with the Chinese Ministry of Science and Technology.[177]

3. India

Among other BRICS nations, the Indian government does not yet appear to have created an AI sandbox, although the Reserve Bank of India launched a regulatory sandbox for financial technology.[178] Nevertheless, there appear to be growing calls within India to develop sector-specific AI sandboxes.[179] Given the size of the Indian market and significant disparities in economic outcomes and technology expertise of different states—an additional argument could be made in favor of sub-national sandboxes in different Indian states and union territories. However, in any such local sandboxes, as well as sector-specific sandboxes at the national level, the roles of different sectoral regulators and central and state governments would need to be clearly delineated. Furthermore, as discussed in the next sub-section, the risks of regulatory privilege granted to politically favored companies remain considerable, especially in the Indian context, which would need to be addressed in designing potential sandbox programs.

4. Russia

In the years before the Russia-Ukraine War, Russia passed several laws aimed at the digital sector, the most well-known among which was the controversial Yarovaya Law ("Закон Яровой"), which increased the

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176 Sofia Baruzzi, *AI Innovation Zones in China: Opportunities for Foreign Investors*, CHINA BRIEFING (Mar. 3, 2021), https://www.china-briefing.com/news/ai-innovation-zones-in-china-opportunities-for-foreign-investors/.

177 The eleven zones are Beijing, Shanghai (Pudong), Shenzhen, Guangzhou, Chengdu, Hangzhou, Jinan-Qingdao, Wuhan, Changsha, Hefei, and Xiamen. *Id.*; 国际科技创新中心 [International Center for Science, Technology, and Innovation], *国家人工智能创新应用先导区"智赋百景"* [National AI Innovation and Application Pilot Zone "Hundred Intelligent Scenes"], https://www.ncsti.gov.cn/kjdt/tzgg/202210/P020221011591635361520.pdf.

178 Elizaveta Gromova & Tjaša Ivanc, *Regulatory Sandboxes (Experimental Legal Regimes) for Digital Innovations in BRICS*, 7 BRICS L.J. 10 (2020).

179 Shashidar K.J., *Regulatory Sandboxes: Decoding India's Attempt to Regulate Fintech Disruption*, OBSERVER RSCH. FOUND. (Nov. 28, 2023), https://www.orfonline.org/public/uploads/posts/pdf/20230524172113.pdf; *see also* Nivedita Krishna, *Why India Needs Sectoral Regulatory Sandboxes for Artificial Intelligence based solutions*, THE TIMES INDIA (Sept. 10, 2023), https://timesofindia.indiatimes.com/blogs/niveditas-musings-on-tech-policy/why-india-needs-sectoral-regulatory-sandboxes-for-artificial-intelligence-based-solutions/.

government's control over data held on Russian territories.[180] In July 2020, the Russian government announced the creation of a regulatory sandbox for digital innovation, although it did not specifically focus on artificial intelligence.[181] The law sought to promote digital innovation in several sectors, including medicine, online commerce, financial markets, and government services.[182] Likewise, the Bank of Russia also launched a fintech sandbox, which still appears functional as of September 2023.[183] Nevertheless, given the exodus of Russian professionals in the technology sector, Western sanctions, and the securitization of the Russian economy, the marginal effects of supposedly pro-market policies might be minimal.[184]

Furthermore, even without an external shock like the current Russia-Ukraine conflict, the rent-seeking aspects of the Russian economy would have exacerbated the potential downsides of poorly implemented sandbox programs. As Brian Knight and Trace Mitchell of the Mercatus Center rightly point out, one disadvantage of a regulatory sandbox is "regulatory privilege"—that is, the set of advantages that a company gains vis-à-vis its competitors outside the sandbox, including regulatory relief, advice, and reputational benefits[185] By ensuring that regulatory insights gained from a sandbox are applied to all similarly situated firms via legal reform, policymakers can reduce potential market distortions due to regulatory privilege. However, in an economy like Russia's, where proximity to political power is often the key to market access, regulatory sandboxes can become another tool where government-aligned firms entrench their competitive positions. Meanwhile, if

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180 Federal Law #374-FZ On Amending Federal Law "On Combating Terrorism" And Certain Legislative Acts of the Russian Federation Regarding the Establishment of Additional Counter-Terrorism Measures and Public Security, STAN. L. SCH. (July 7, 2016), https://wilmap.stanford.edu/entries/federal-law-374-fz-amending-federal-law-combating-terrorism-and-certain-legislative-acts.

181 Byungkom Lim, Gary E. Murphy, & Evgenii Lebedev, *В России принят закон о регуляторных песочницах* [Russia has adopted a law on regulatory sandboxes], DEBEVOISE & PLIMPTON (2020), https://www.debevoise.com/-/media/files/insights/publications/2020/09/20200918-russian-law-on-regulatory-sandboxes-rus.pdf.

182 *Id*.

183 BANK OF RUSSIA, *Регулятивная песочница Банка России: теперь удобнее и проще* [The Bank of Russia will compile a rating of the accessibility of credit institutions for people with disabilities] (2023), https://cbr.ru/eng/press/event/?id=16996; Karine Hadji, *Регуляторные песочницы в России и в мире* [Regulatory Sandboxes in Russia and the World], ВСЕРОССИЙСКАЯ АКАДЕМИЯ ВНЕШНЕЙ ТОРГОВЛИ [ALL-RUSSIAN ACADEMY OF FOREIGN TRADE] (July 31, 2020), https://www.vavt-imef.ru/wp-content/uploads/2020/07/2020.07.31_Песочницы_с-кратким-описанием-и-ссылкой-на-текст-закона_для-публикации-на-сайт-и-ФБ_чистовой-вариант.pdf.

184 *See generally* Johannes Wachs, *Digital Traces of Brain Drain: Developers During the Russian Invasion of Ukraine,* EPJ DATA SCI. (2023), https://doi.org/10.1140/epjds/s13688-023-00389-3; Margarete Klein & Nils Holger Schreiber, *Der Angriff auf die Ukraine und die Militarisierung der russischen Außen- und Innenpolitik [The Attack on Ukraine and the Militarisation of Russian Foreign and Domestic Policy]*, SWP (Dec. 2022), https://www.swp-berlin.org/publikation/der-angriff-auf-die-ukraine-und-die-militarisierung-der-russischen-aussen-und-innenpolitik.

185 *See* Knight & Mitchell, *supra* note 3, at 437.

the legal insights gained through a regulatory sandbox are not used for broader legal reforms to create a more innovative and competitive market, the marginal pro-innovation benefits of sandboxes might remain minimal.

This broader point goes beyond the case of Russia and could easily apply to many emerging-market countries, from Brazil to India and Indonesia. A regulatory sandbox can be an effective policy tool, but its effectiveness can vary significantly depending on how it is designed and implemented and how it interacts with different components of the broader political, economic, and legal systems. Enacting legislation to create a sandbox is not difficult in most jurisdictions, especially given the availability of boilerplate templates that could be copied from other countries. However, creating effective sandbox programs requires more than that: having the right policy objectives and regulatory design, developing well-thought entry and selection criteria, ensuring fair selection and regulatory treatment, and using the lessons from the sandbox for more comprehensive reforms. These factors will ultimately influence whether an AI sandbox contributes to creating a more market-friendly, innovative regulatory environment and ecosystem.

As more emerging-market countries seek to create AI sandboxes to promote innovation, these factors are especially worth considering. Other jurisdictions that are currently considering the creation of an AI sandbox include Brazil, with the Brazilian Data Protection Authority having concluded a consultation last year that sought expert opinions on designing an AI sandbox.[186] While precise details of Brazil's AI sandbox strategy remain to be seen, the Brazilian data protection regulator's explanation of the rationale for creating an AI sandbox, thoughtful questions related to regulatory design, and its insightful assessment of the global AI regulatory landscape—as detailed in the accompanying technical paper on AI sandboxes—were all steps in the right direction.[187] Furthermore, the Colombian and Chilean governments have also expressed interest in creating regulatory sandbox programs to promote AI innovation.[188] Well-designed AI sandboxes, when implemented effectively in a regulatory environment characterized by the rule of law, could pave the way for thoughtful, innovation-friendly AI regulation and help promote growth and innovation in emerging-market countries.

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186 GOV'T OF BRAZIL, *supra* note 80.

187 *Id.*; *see also Regulatory Sandbox Benchmark Technical Study (Public Version)*, MINISTÉRIO DA JUSTIÇA E SEGURANÇA PÚBLICA [MINISTRY OF JUSTICE & PUBLIC SECURITY], (2023), https://www.gov.br/anpd/pt-br/documentos-e-publicacoes/documentos-de-publicacoes/sandbox_regulatorio___estudo_tecnico__versao_publica_.pdf/view.

188 UNESCO, *Chile: Artificial Intelligence Readiness Assessment Report (2023)*, https://unesdoc.unesco.org/ark:/48223/pf0000387216; *see also MinTIC estructurará 10 'sandbox' regulatorios para acelerar los ecosistemas de innovación en Colombia* [*MinTic Will Structure 10 Regulatory "Sandboxes" to Accelerate Innovation Ecosystems in Colombia]*, MINISTERIO DE TECNOLOGÍAS DE LA INFORMACIÓN Y LAS COMUNICACIONES DE COLOMBIA [MINISTRY OF INOFRMATION & COMMUNICATION TECHNOLOGIES OF COLOMBIA] (2024), https://www.mintic.gov.co/portal/inicio/Sala-de-prensa/Noticias/281130.

IV. CONSIDERATIONS FOR DESIGNING EFFECTIVE AI REGULATORY SANDBOXES

Gaining a comparative view of regulatory strategies and challenges faced by different jurisdictions can help lawmakers and regulators design more effective sandboxes for artificial intelligence. Based on the analysis of select AI sandboxes worldwide, this section presents a series of observations to identify guiding principles and provide regulatory insights for policymakers. While these recommendations are not intended to be exhaustive, they aim to contribute additional perspectives to assist policymakers in refining AI sandbox strategies at the national and supranational levels.

A. *Choice of Regulatory Models for AI Sandboxes*

One of the initial considerations in developing a country's sandbox strategy is whether to establish single or multiple AI sandboxes and whether these should be under the jurisdiction of single or multiple regulators. While this decision is multifaceted, the analytical framework provided by the UK government's AI White Paper offers helpful insights. As previously discussed, lawmakers have four different regulatory models to consider: i) single-sector sandbox with a single regulator; ii) multi-sector sandbox with a single regulator; iii) single-sector sector with multiple regulators; and iv) multi-sector sandbox with multiple regulators (Table 1).[189]

With this framework in mind, a few observations are worth noting. First, there appears to be a growing regulatory trend toward establishing multiple AI sandboxes. For example, the first draft of the EU's AI Act only recommended that Member States create an AI Sandbox.[190] In contrast, the final text suggests a significant shift, with Member States now required to create or join at least one AI sandbox.[191] Likewise, the UK government, as detailed in the AI White Paper, is exploring plans to set up multiple sandboxes,[192]

Second, the decision to create multiple sandboxes raises the question of choosing the most appropriate models for such programs. Developing an effective sandbox strategy will ultimately require a degree of regulatory experimentation and an iterative approach. Therefore, governments might consider launching one or two pilot programs initially. These pilot sandboxes should be straightforward to design and implement and should be introduced in areas or sectors most likely to benefit from a sandbox.

To that end, governments could create a multi-sector, single-regulator AI sandbox under the supervision of a country's data protection or artificial intelligence regulator. For example, the Spanish government appears to have

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189 U.K. DEP'T FOR SCI., *supra* note 17, at n.142.

190 Artificial Intelligence Act, art. 53(1), EUR. PARL. DOC. TA 138 (2024).

191 *Id.* at art. 57.

192 U.K. DEP'T FOR SCI., *supra* note 17, at n.142.

adopted this model for its sandbox, providing a potential template for countries planning to launch their first sandbox. As such programs expand and attract companies from different sectors, the involvement of additional regulators might become necessary. This pilot sandbox can be gradually developed into a more comprehensive multi-sector, multi-regulator AI sandbox.[193]

Lawmakers and regulatory authorities could also consider introducing a single-sector, single-regulator sandbox. To that end, they must identify a sector that falls under the supervision of a single regulator where market participants—including companies, investors, and consumers — support the concept of a sandbox. The appropriate sector might vary from country to country, but identifying the right sector can be crucial in determining the success of the pilot sandbox. Drawing on insights from the pilot sandbox program(s), governments can adopt more complex regulatory models, such as the single-sector, multiple-regulator sandbox and multiple-sector, multiple-regulator sandbox.

Lawmakers and regulators might also benefit from considering an additional factor: in most jurisdictions, designing a single-sector sandbox will be more straightforward than a multiple-sector sandbox. However, in certain jurisdictions, the fragmentation of regulatory authority across multiple regulators can exacerbate the difficulties of designing effective sandboxes for certain sectors. Whether a specific sector will require a sandbox with single or multiple regulators will vary by jurisdiction, which can be a critical consideration in developing pilot sandbox programs.

For example, compared to the United States, where the financial regulatory architecture is characterized by complex horizontal and vertical fragmentation, creating a sector-specific fintech AI sandbox is likely to be more straightforward in the UK and Australia because the latter two would most likely implicate the single-sector, single-regulator model.[194] For instance, if the FCA had not already launched a fintech sandbox, and the UK government wanted to design an AI sandbox for financial services, such a sandbox would most likely be placed under the FCA's jurisdiction. In Australia, a similar program would likely require the regulatory supervision of the Australian Securities and Investments Commission, which currently runs the country's Enhanced Regulatory Sandbox (ERS).[195] In contrast, the presence of multiple U.S. financial regulators at the federal and state levels means that an effective AI sandbox for financial services would necessitate the single-sector, multiple-regulator model, thereby involving significantly more regulatory complexity. Consequently, whereas financial services might be a suitable sector for a sector-specific pilot AI sandbox in jurisdictions like Australia and the

193 *Id.*

194 Allen, *supra* note 3, at 579.

195 *Enhanced Regulatory Sandbox (ERS)*, AUSTL. SEC. & INV. COMM'N (2024), https://asic.gov.au/for-business/innovation-hub/enhanced-regulatory-sandbox-ers/ (last visited Jan. 24, 2023).

UK, other sectors may be better suited for similar initiatives in the United States.

B. *Mechanisms to Review Regulatory Insights*

To maximize the benefits of AI sandboxes, policymakers need to ensure that regulatory insights gained from such programs are generalized and applied to the broader economy. In the context of regulatory sandboxes, it is helpful to distinguish between short-term, direct benefits for the participating firm and consumers and longer-term, systemic benefits for the broader economy. As participating firms receive regulatory advice and fine-tune the proposed AI product or service, such regulatory support represents a direct and immediate benefit to the sandbox firms and their consumers. However, lawmakers and regulators should also recognize the less immediate but systemic benefits that can arise from applying insights gained from sandbox projects more widely.

However, to realize such benefits, lawmakers and regulators must focus on deriving broader regulatory insights from sandbox projects and using such insights to develop and refine regulations. To that end, policymakers should consider implementing formal mechanisms to conduct periodic reviews of sandbox data and regulatory lessons and to evaluate existing and potential regulations. Likewise, sandbox programs could serve as an additional tool for monitoring AI safety risks, assessing whether current regulations adequately address these risks, and determining whether new statutory measures are necessary.

C. *Measures to Mitigate Regulatory Privilege*

While designing sandbox programs, governments should consider taking steps to address potential adverse effects. One particular concern is the issue of regulatory privilege, which refers to the advantages that firms participating in a sandbox may have vis-à-vis their similarly situated competitors outside the sandbox.[196] This issue can be particularly acute in emerging-market countries with weaker institutional frameworks and lower levels of transparency, but it also poses significant challenges in more developed economies. Several measures could be helpful in mitigating the adverse impacts of regulatory privilege, which are discussed below.

First, any regulatory relief or waiver provided through AI sandboxes should be granted based on an identified regulatory shortcoming. For example, if a cumbersome regulation prevents the offering of a certain AI-enabled product or service, a firm could receive a regulatory exemption from the

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[196] Knight & Mitchell, *supra* note 3, at 473.

specific regulation during the sandbox testing period.[197] However, such insights should be used as the basis for broader regulatory reform so that other similarly situated firms are also exempted from the regulation in question. Otherwise, regulatory sandboxes risk becoming a tool through which firms can gain regulatory privilege while firms outside the sandbox continue to suffer from onerous rules.[198] Only when the regulatory insights from AI sandboxes are used to promote broader policy reform and benefit all similarly situated firms do regulatory sandboxes become a more effective tool in pursuing evidence-based policy reform.

Second, any benefits that participating firms receive through the regulatory sandbox should be time-limited to minimize potential market disruptions.[199] In determining this time limit, or the duration of the sandbox test, two general principles should be considered. The testing period should not be so long that it leads to unnecessary waste of regulatory resources while allowing companies to enjoy regulatory advantages vis-à-vis their competitors.[200] However, the testing duration needs to be long enough so that firms have adequate time to bring their proposed AI system into compliance and regulators can gather enough data about how current and proposed regulations affect participating companies.[201]

While the appropriate testing period will likely vary by sector and the nature of the proposed product, the testing duration of other regulatory sandboxes can provide a helpful benchmark. For example, although the British and Spanish AI sandbox proposals do not specify a testing period, the Norwegian AI sandbox test lasts between three and six months.[202] Meanwhile, France's CNIL sandbox has a support phase ("phase d'accompagnement") of six months, followed by an implementation phase ("phase d'implémentation") and a phase for returning to the market ("phase de retour à l'écosystème"). Additionally, the testing duration of fintech sandboxes can provide an additional frame of reference for AI sandboxes. Nevertheless, it is important to bear in mind that the appropriate testing duration might vary by sector.[203] As a result, instead of setting testing duration via statute, it would be more appropriate to provide a recommended range and enable regulators to determine the precise testing duration on a case-by-case basis.[204] At the same time, lawmakers and regulators should ensure that similar products and services receive similar testing duration to minimize regulatory privilege and ensure fair treatment for all firms.

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197 *Id.* at 459–60.

198 *Id.* at 473.

199 *Id.*; Allen, *supra* note 3, at 638–39.

200 Knight & Mitchell, *supra* note 3, at 534; Allen, *supra* note 3, at 638.

201 Nabil, COMPETITIVE ENTER. INST., *supra* note 2, at 7.

202 *Reports*, DATATILSYNET, *supra* note 142.

203 Nabil, COMPETITIVE ENTER. INST., *supra* note 2, at 9–12.

204 *Id.*

D. *Eligibility and Selection Criteria*

Regulatory sandboxes require well-developed eligibility and selection criteria to ensure the selection process is fair, unbiased, and conducive to regulatory learning and reform.[205] Without evidence-based evaluation criteria, the selection process risks becoming biased. For example, sandbox regulators might favor politically favored firms or firms with ties to the regulators over those with greater potential for innovation and regulatory capacity building. While the Norwegian AI sandbox and the proposed British AI sandbox do not appear to have published potential selection criteria for applications, the Zurich AI sandbox has established 11 criteria against which potential applicants are evaluated (Table A1).[206] These criteria include product-specific considerations, such as the readiness of a proposed project for testing in the sandbox and its compliance with specific technical and non-technical feasibility requirements.[207] Additionally, applicants are asked a set of questions to assess the proposed project's broader innovation potential and determine whether supervising the project would help Swiss authorities enhance their regulatory expertise (Table A1).[208]

The European Union's AI Act does not specify a formal list of evaluation criteria for EU-aligned AI sandboxes at the national level. However, the European Commission is expected to develop common principles for eligibility and selection criteria through future implementing acts to prevent regulatory fragmentation.[209] Currently, Member States enjoy considerable freedom in specifying the design of sandbox programs, as well as eligibility and selection criteria, but that could change with future implementing acts.[210] Spain, which was the first EU country to pass legislation establishing a statutory basis for its EU-aligned sandbox, has published a list of selection criteria for its AI sandbox, providing a potential template for other jurisdictions, especially within the European Union.[211]

More specifically, as specified in the Royal Decree 817/2023, the Spanish AI sandbox has 11 sandbox criteria, which differ substantially from the Zurich AI sandbox.[212] Compared to those of the Zurich sandbox, the Spanish

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205 *See generally* Knight & Mitchell, *supra* note 3, at 454–57; Allen, *supra* note 3, at 624–30.

206 *Selektionskriterien der Innovation-Sandbox für Künstliche Intelligenz" ["Selection Criteria for Innovation Sandbox for Artificial Intelligence"]*, AMT FÜR WIRTSCHAFT UND ARBEIT, KANTON ZÜRICH [OFFICE FOR ECONOMY AND LABOR, CANTON OF ZÜRICH], https://www.zh.ch/content/dam/zhweb/bilder-dokumente/themen/wirtschaft-arbeit/wirtschaftsstandort/dokumente/innovation-sandbox_selektion-skriterien.pdf (last updated March 2022).

207 *Id.*

208 *Id*.

209 Artificial Intelligence Act, arts. 58(1)(a), EUR. PARL. DOC. TA 138 (2024).

210 *Id.*

211 ROYAL DECREE 817/2023, *supra* note 28, at art. 8(2).

212 *Id.*

AI sandbox's evaluation criteria show a greater emphasis on the proposed project's technical specifications and alignment with existing data protection regulations and other EU requirements. For example, in selecting participating firms, Spanish regulators will evaluate the technical complexity of the proposed AI systems, explainability, algorithmic transparency, and broader impacts on the economy and society (Table A2).[213] Likewise, they will also consider the AI Act's risk classification levels and the testing readiness of the proposed project (Table A2).[214] To that end, Spanish regulators intend to ensure a representative grouping of AI systems with varying risk classification levels and testing readiness levels, as well as a mix of large companies and start-ups (Table A2).[215] A varied representation of sandbox participants can provide valuable insights into how AI Act obligations affect different types of AI systems in various sectors. Such insights could be helpful in assessing whether adjustments to the EU's risk classifications, risk-rated regulations, and broader AI rules will be needed in the future.

As more jurisdictions develop selection criteria for regulatory sandboxes, caution is essential. Policymakers should be careful of overly restrictive eligibility and selection criteria, which can prevent otherwise innovative firms from participating in AI sandboxes— a major concern for several U.S. state-level sandbox programs.[216] For example, some U.S. fintech and insurance sandboxes have implemented strict state residency requirements for sandbox applicants, preventing out-of-state and foreign companies from applying to these programs.[217] Thus far, Switzerland and the European Union have avoided creating overly restrictive entry criteria—a regulatory approach that should be maintained. As a general principle, while developing generally liberal entry criteria, regulators should seek to apply them fairly and consistently. Selecting high-impact projects with the greatest potential to promote innovation and regulatory learning is crucial to the long-term effectiveness of AI sandboxes.

E. *Innovation Hubs and Reciprocal Sandbox Agreements*

Regulatory sandboxes can play an important role in promoting international economic and regulatory cooperation and elevating the global profile of a particular jurisdiction. As mentioned, the Spanish, Swiss, and Norwegian sandboxes do not require sandbox participants to be based in the respective jurisdictions. This policy is a step in the right direction as it can allow sandbox applications from across the European Union and beyond. Likewise,

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213 *Id.*

214 *Id.*

215 *Id.*

216 Nabil, COMPETITIVE ENTER. INST., *supra* note 2, at 7.

217 *Id.*

under the AI Act, a Member State could join the sandbox program offered by another EU country to fulfill the requirement that each Member State have at least one AI sandbox.[218] Beyond such measures, innovation hubs and reciprocal sandbox arrangements can also help promote international cooperation.

First, innovation hubs can help complement a given jurisdiction's AI sandbox strategy. Innovation hubs serve as a platform for dialogue between regulators and businesses, allowing regulators to advise businesses on identifying market opportunities and achieving regulatory compliance, in addition to providing information about business registration, tax, and immigration.[219] Even without sandbox programs, innovation hubs can help promote awareness and attract foreign start-ups and entrepreneurs. The European Union has launched a network of European Digital Innovation Hubs (EDIHs), representing a step in the right direction.[220] Additionally, certain jurisdictions, such as Estonia, have created effective innovation hubs for the financial services sector, which can provide a helpful template for other countries.[221]

In the context of AI sandboxes, innovation hubs can play a pivotal role by providing potential applicants with information and regulatory advice about the application process. For example, these hubs can assist companies and start-ups in deciding whether to apply for a general-purpose AI sandbox or a sector-specific one. Due to limited regulatory resources, sandboxes often restrict the number of participants they can admit at any given time. Consequently, otherwise highly qualified projects might be overlooked due to factors beyond the applicants' control, such as the need for a diverse mix of companies from various sectors and projects with different levels of safety risks and commercial maturity.[222] Innovation hubs can help mitigate this challenge by facilitating informal consultations, enabling regulators to advise companies while spending limited regulatory resources more efficiently.

Lastly, governments should consider reciprocal sandboxes as a tool to promote international economic and regulatory cooperation.[223] Reciprocal sandbox agreements would allow participants in one country's sandbox to gain automatic or simplified access to another state's regulatory sandbox.[224] For example, start-ups from a U.S. or UK sandbox could enjoy simplified access to the Zurich sandbox due to a reciprocal agreement between the

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[218] Artificial Intelligence Act, art. 57(1), EUR. PARL. DOC. TA 138 (2024).

[219] For example, *see ASIC's Innovation Hub and our approach to regulatory technology*, AUSTL. SECS. & INV. COMM'N, https://download.asic.gov.au/media/4270022/rep523-published-26-may-2017.pdf (May 2017).

[220] *European Digital Innovation Hubs*, EUR. COMM'N (last visited Jan. 30, 2024), https://digital-strategy.ec.europa.eu/en/activities/edihs.

[221] For example, *see* Finantsinspektsioon Innovation Hub Report 2022, Finantsinspektsioon, https://www.fi.ee/sites/default/files/2022-09/Innovatsioon_FI_eng_w.pdf (last visited Apr. 8, 2024).

[222] For example, see the evaluation criteria of the Spanish AI sandbox. ROYAL DECREE 817/2023, *supra* note 28, at art. 8(2).

[223] Ryan Nabil, NAT'L TAXPAYERS UNION FOUND., *supra* note 71.

[224] *Id.*

respective jurisdictions. Such programs would make it easier for firms to ensure that their offered product complies with AI regulations in both jurisdictions. While no governments are currently known to have signed such reciprocity agreements for AI sandboxes, several jurisdictions have endorsed the concept. For example, the legislation creating multiple U.S. state-level fintech and insurance sandbox programs authorizes state regulators to negotiate reciprocal sandbox agreements with their foreign counterparts.[225] Although the constitutionality of such programs under U.S. law could be challenged, there appears to be a growing interest in reciprocal sandbox arrangements at the state level.

The European Union could play a vital role in pioneering reciprocal sandbox programs at the regional and international levels. Under Article 57 of the AI Act, a Member State could join an existing sandbox to fulfill the requirement of having at least one AI sandbox, as long as this sandbox "provides an equivalent level of national coverage for the participating Member States."[226] Such programs could be designed in a way that participating companies receive regulatory advice from regulators of multiple countries.[227] Comparable arrangements could also be created with non-EU countries—like Canada, Japan, Switzerland, and the UK—which are recognized by the European Commission as having established adequate data protection standards.[228] Although transatlantic divergences in AI and data policies might pose a certain degree of challenge, such differences might be precisely the reason why firms would benefit from reciprocal sandbox programs, especially as it becomes increasingly important to bring AI-enabled products into compliance with distinct legal regimes.[229]

F. *Additional Considerations for the U.S. Federal Government*

Since the design of regulatory sandboxes is context-specific, some regulatory insights and recommendations apply in the context of some jurisdictions but not necessarily others. While the United States has not yet created a regulatory sandbox for AI, there appears to be a growing interest in developing such programs at the federal and state levels. While the precise design of these sandboxes will require careful consideration, a few general principles are worth considering.

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225 *See* Nabil, COMPETITIVE ENTER. INST., *supra* note 2.

226 Artificial Intelligence Act, art. 57(1), EUR. PARL. DOC. TA 138 (2024).

227 *Id.*

228 *Adequacy decisions*, EUR. COMM'N, https://commission.europa.eu/law/law-topic/data-protection/international-dimension-data-protection/adequacy-decisions_en (last visited Jan. 30, 2024).

229 Ryan Nabil, *The new EU-US data agreement is facing familiar privacy challenges*, THE HILL (Oct. 20, 2023), https://thehill.com/opinion/technology/4267142-the-new-eu-u-s-data-agreement-is-facing-familiar-privacy-challenges.

First, as in the UK, U.S. AI rules will vary by sector and the context in which AI applications are used. Although the Biden administration's recently published AI strategy has several shortcomings, its endorsement of a sector-based approach to AI governance is the right approach in the U.S. regulatory context.[230] As the United States pursues a sector-based approach to AI, it might be more beneficial to develop both general-purpose and sector-specific AI sandboxes rather than relying solely on a single all-purpose AI sandbox.[231] For example, the U.S. financial regulatory landscape differs notably from those of the education and healthcare sectors, each featuring a distinct set of regulators and legal frameworks. Given AI applications in various industries might be subject to distinct regulatory frameworks, multiple sector-specific sandboxes might be more effective in developing evidence-based AI rules tailored to each sector.

One major challenge in the U.S. context is regulatory fragmentation, as evidenced by the difficulties that U.S. regulatory authorities experienced in developing successful fintech sandbox programs.[232] The division of financial regulatory authority among various federal regulators and, to a lesser extent, between federal and state authorities has been a significant challenge for the type of regulatory supervision and relief that has been crucial to the success of fintech sandbox programs elsewhere.[233] Unsurprisingly, the most prominent regulatory sandbox program in the United States has not been in the area of financial services but in (Utah's) legal services market, which is not characterized by the same degree of regulatory fragmentation.[234] Creating AI sandboxes will likely pose an additional layer of regulatory complexity since they would most likely require joint supervision by a future U.S. privacy or AI regulator and the relevant sectoral regulator (or regulators in case of the proposed AI system falling under the overlapping jurisdiction of multiple agencies).[235] Without establishing a clear legal framework and statutory mechanisms for interagency coordination, U.S. AI sandboxes might face challenges that restrict their long-term effectiveness vis-à-vis comparable programs in jurisdictions with more streamlined, less fragmented regulatory environments.[236]

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230 Cobun Zweifel-Keegan, *A view from DC: Sectoral rules make US AI governance policy leader*, INT'L ASS'N PRIV. PROS. (Oct. 20, 2023), https://iapp.org/news/a/a-view-from-dc-sectoral-rules-make-us-ai-governance-policy-leader.

231 *Id.*

232 *See* Appaya et al., *supra* note 6.

233 *Id.*

234 *Utah Office Of Legal Services Innovation*, UTAH OFF. OF LEGAL SERVS. INNOVATION, https://utahinnovationoffice.org/authorized-entities/ (last visited Jan. 24, 2023) (More specifically, the Utah Supreme Court's Office for Legal Innovation has created a legal sandbox program, which allows non-lawyer-owned firms, including tech firms, to provide certain types of legal services); *see* Nabil, COMPETITIVE ENTER. INST., *supra* note 2, at 7.

235 *See* Ryan Nabil, NAT'L TAXPAYERS UNION FOUND., *supra* note 71, at 9–10.

236 *Id.*

G. *Additional Considerations for U.S. States*

Compared to the federal government, U.S. states have demonstrated greater interest in creating sandbox programs in the context of financial services. Despite this enthusiasm, state-level sandboxes have encountered considerable challenges—often due to their inability to provide sufficient regulatory relief, overly restrictive entry criteria, and the overall business and regulatory environments in individual states.[237] However, with the right approach, state governments could play an important role in initiating AI sandboxes, particularly if the federal government continues to lag in establishing such programs. Against this backdrop, how could state governments navigate the evolving regulatory sandbox landscape of AI sandboxes and develop effective AI sandbox programs at the state level?

The response will ultimately depend not only on ongoing federal AI policy developments but also on individual states' economic and political circumstances and policy objectives. As the AI regulatory landscape continues to evolve, a few general principles and observations are worth noting. Given that the U.S. federal government appears to be pursuing a sector-based approach to AI regulation, state governments should identify areas predominantly within their regulatory remit where federal initiatives are less likely.

Drawing an analogy to European Union law could be particularly helpful in this context. In EU law, there are three types of "regulatory authority" or, more accurately, "competence" in EU parlance. These include i) "exclusive EU competence," as outlined in Article 2 of the Treaty on the Founding of the European Union (TFEU), where only the EU has the authority to enact legally binding acts; ii) "shared competence," where both the EU and member can legislate and adopt legally binding acts, as per Article 5 TFEU; and iii) "supporting competence," where the EU's role is limited to coordinating, supporting, or implementing the policies of EU Member States under Article 6.[238] While an imperfect analogy, it can provide valuable insights into areas where individual U.S. states might possess a comparative advantage in developing sandbox programs.

Instead of focusing on the areas where the federal government dominates (akin to the first group in the EU analogy), state governments are likely to find more success in areas where they enjoy substantial regulatory authority, corresponding to the second and third groups of competences. For example, financial services and insurance are two sectors that might benefit from state-level AI sandboxes. Indeed, as already discussed, many U.S. states have already designed financial technology and insurance sandbox programs, with Arizona and Hawaii's sandboxes having admitted a considerable number of

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[237] *See* Nabil, COMPETITIVE ENTER. INST., *supra* note 2, at 11–12.

[238] The Treaty on the Functioning of the European Union, Official Journal of the European Union, European Union, 326/50, Oct. 26, 2012, C 326/47.

participants.[239] These initiatives can serve as a foundation for launching new sector-specific AI sandboxes for financial services or making AI applications a thematic focus of existing fintech and insurance sandboxes.

However, the legal services sector, which remains the preserve of individual U.S. states, likely represents the most promising area for AI sandboxes at the state level. In terms of the number of participants admitted as of November 2022, the Utah Supreme Court's legal sandbox remains by far the best-performing U.S. sandbox at both federal and state levels.[240] By enabling non-lawyer-owned companies to provide certain legal services within a sandbox, AI-focused legal sandboxes can significantly reduce the costs of certain legal services (e.g., filling out real estate, marriage, and immigration-related forms) and improve access to justice for low-income Americans.[241] Following Utah, the Law Societies of British Columbia and Ontario—bar associations that regulate legal services in the two Canadian provinces—have also launched similar sandbox programs.[242]

Whereas the support for fintech sandboxes might display partisan leanings, legal sandboxes might be more likely to garner bipartisan support,[243] particularly due to their potential to lower the costs of legal services and expand access to justice.[244] According to the Legal Services Corporation, 92 percent of low-income Americans reported not receiving any or adequate legal assistance for their civil legal challenges.[245] Nevertheless, unlike several Common Law jurisdictions, such as England and Wales, almost all U.S. states prohibit non-lawyers, including technology firms, from co-owning legal practices and providing legal services.[246] However, legal sandbox programs, which allow non-lawyers (including start-ups and tech firms) to provide limited legal services, could introduce much-needed competition and innovation in the sector, thereby lowering the cost of such services.[247] Since the launch of Utah's legal sandbox in August 2020, breakthroughs in

239 *See* Nabil, COMPETITIVE ENTER. INST., *supra* note 2, at 11.

240 *Id.*

241 *Activity Report*, UTAH, *supra* note 13; *see Utah Office Of Legal Services Innovation*, *supra* note 234.

242 *Innovation Sandbox*, L. SOC'Y OF BRITISH COLUMBIA (Jan. 24, 2023), https://www.lawsociety.bc.ca/priorities/innovation-sandbox.

243 For example, conservative and libertarian-leaning groups, such as the Libertas Institute and the American Legislative Exchange Council (ALEC), have been particularly active in advocating fintech regulatory sandboxes at the state level. In contrast, the support for legal sandboxes, while not as widespread, appears to have come from a wide range of groups, including university-affiliated think tanks, such as the Institute for the Advancement of the American Legal System of the University of Denver).

244 Ryan Nabil, *Regulatory sandbox programs can promote legal innovation and improve access to justice*, THE HILL (Oct. 9, 2021), https://thehill.com/opinion/judiciary/576041-regulatory-sandbox-programs-can-promote-legal-innovation-and-improve-access.

245 *The Justice Gap: The Unmet Civil Legal Needs of Low-income Americans*, LEGAL SERVS. CORP., at 19 (April 2022), https://lsc-live.app.box.com/s/xl2v2uraiotbbzrhuwtjlgi0emp3myz1.

246 Ryan Nabil, THE HILL, *supra* note 244.

247 *Id.*

generative AI have presented even greater opportunities to automate and reduce costs for a range of legal services.[248] As a result, legal tech represents an ideal starting point for state governments and courts to establish an AI sandbox and broaden access to justice.

Beyond the financial and legal services sectors, U.S. state governments can monitor regulatory developments at the federal level and recalibrate their AI strategies accordingly. If the federal government remains inactive in establishing AI sandboxes, it could present new opportunities for other state-level initiatives. An educational technology sandbox is one potential area for exploration, while sandboxes focused on autonomous vehicles, agricultural technology, and automated manufacturing also merit consideration.

In designing such programs, state regulators might face significant constraints, particularly in providing relief from certain federal laws. However, even in such cases, state-level sandboxes could still prove effective. For example, they could offer regulatory advice for compliance with applicable federal regulations—as the Norwegian sandbox does with respect to EU laws, which Norway, as a non-EU member, has no power to change.[249] Additionally, state governments could still provide tax and other incentives to encourage participation in these sandboxes. Combining state-level sandboxes with innovation hubs could be particularly effective in raising awareness among domestic and international firms about business opportunities at the state level. For instance, a foreign start-up might apply to a state-level sandbox in Arkansas or Florida to bring its proposed AI product in compliance with U.S. law and enter the U.S. market. Such considerations will, of course, need to be reflected in the design of state-level AI sandboxes. Accordingly, state governments must establish liberal entry criteria to ensure that innovative companies and start-ups from both the United States and overseas can participate in their AI sandbox programs.

H. Additional Considerations for the European Union[250]

While the European Union's revised approach to regulatory sandboxes is a step in the right direction, it faces several challenges and concerns that European policymakers must consider, particularly as more countries launch EU-aligned sandboxes at the national level. First, although many regulatory sandboxes offer some regulatory relief, often in the form of regulatory

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[248] *Activity Report*, UTAH, *supra* note 13; *see Utah Office Of Legal Services Innovation*, *supra* note 234.

[249] *Hva skjer med sandkassene i Norge?* [*What happens to the sandboxes in Norway?*], DATATILSYNET, https://www.datatilsynet.no/aktuelt/aktuelle-nyheter-2023/erfaringsseminar-for-sandkasser (last visited Apr. 7, 2023).

[250] This section builds on the author's previous article on the topic. Nabil, AUSTL. INST, *supra* note 106.

exemption or expedited registration,[251] the EU's AI sandbox appears to provide no such relief, which could limit long-term private-sector interest in such programs.[252] Second, as different EU Member States launch sandboxes at the national level, the European Union would benefit from closer attention to regulatory divergence—an issue that it might address through future implementing acts under Article 58 of the AI Act.[253]

Third, the European Union must ensure that regulatory insights from the national-level AI sandboxes are used to facilitate regulatory calibration and reform at the EU level. The final text of the AI Act recognizes regulatory learning as an objective of AI sandboxes, marking a positive step forward.[254] To that end, the AI Act mandates national authorities to submit annual reports on sandbox outcomes, best practices, lessons learned, recommendations on the sandbox setup, and, where applicable, recommendations on regulatory adjustments for the AI Act.[255] While that is a step in the right direction, the EU could further benefit from more thorough and focused evaluation mechanisms at the national level to evaluate the effectiveness of and assess the need for recalibrating existing regulations. A more rigorous evaluation at the national level also needs to be complemented by enhanced EU-level mechanisms to evaluate and compare the results from different national sandboxes. Strengthening such mechanisms through subsequent implementing acts and delegated legislation can help ensure that regulatory sandboxes are used to develop and maintain an evidence-based, innovation-friendly EU approach to AI governance.

Fourth, as the European Union refines its sandbox strategy, it must pay particular attention to the evaluation criteria for admitting companies interested in the AI sandbox programs. While the AI Act does not provide a list of eligibility and selection criteria, future implementing acts under Article 58 are expected to establish common principles to avoid regulatory fragmentation.[256] When developing these criteria, a few concerns should be considered. While preventing regulatory fragmentation is an important goal, it must be balanced with the need to provide Member States greater freedom in designing AI sandboxes that reflect individual EU countries' policy objectives and conditions. That is why, to the extent possible, future implementing legislation should seek to provide Member States with flexibility in designing such criteria. Likewise, as discussed earlier, evidence-based selection criteria and application procedures will be crucial in minimizing regulatory privilege and potential biases in selection processes. Therefore, selection criteria should be carefully developed so that they can promote innovation and regulatory

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251 Nabil, COMPETITIVE ENTER. INST., *supra* note 2.
252 Artificial Intelligence Act, art. 57, EUR. PARL. DOC. TA 138 (2024).
253 *Id.* at art. 58.
254 *Id.* at recital (139), art. 58(2)(i).
255 *Id.* at art. 57(16).
256 *Id.* at art. 58(1).

learning. To that end, the selection criteria in the Spanish AI sandbox—which seeks to ensure a variety of company sizes, sectors, risk levels, and commercial maturity of AI systems—warrants closer consideration from Member States.[257] A more representative set of firms can be especially helpful in understanding how AI rules affect various firms in different sectors. Entry criteria should also not be set so narrowly that they exclude otherwise well-qualified participants from participating in the sandbox. To that end, EU authorities would do well to pay attention to U.S. fintech sandboxes, where overly strict entry criteria have contributed to their lack of success.[258]

Finally, the European Union could distinguish itself from other jurisdictions by pursuing a more internationalized approach to regulatory sandboxes. At a time when China and the United States, two of the world's leading tech players, increasingly appear to turn inwards, the EU could advocate a less restrictive approach to tech governance, and regulatory sandboxes could play an important role in this strategy. The EU's AI sandbox strategy currently shows considerable openness, for example, in that it does not have overly restrictive entry criteria and that EU Member States could join the regulatory sandbox offered by another EU country.[259] The EU could go one step further by launching reciprocal or joint sandbox arrangements with like-minded jurisdictions—such as Britain, Japan, and Switzerland—which provide an equivalent level of data protection according to the Commission's assessment.[260] These reciprocal arrangements could allow companies from these countries to join the sandbox of an EU country (or even an EU-level sandbox) and benefit from the regulatory supervision and advice from multiple jurisdictions. Such innovative approaches could go a long way towards regaining the EU's reputation as an open and innovation-friendly jurisdiction at a time of growing tech protectionism from China and the United States.

I. *Additional Considerations for EU Member States*

It is helpful to consider possible national policies that individual EU countries can take while remaining within the bounds of the broader European AI governance framework. In this context, several points are worth considering. First, while the implementing acts and delegating legislation might add further rules, the AI Act currently appears to grant considerable autonomy in how Member States design their sandbox program. For example, while each EU country must create or join at least one national-level AI sandbox, the decision of how many and which sandboxes to create and join is

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257 ROYAL DECREE 817/2023, *supra* note 28, at Art. 8(2).

258 Nabil, COMPETITIVE ENTER. INST., *supra* note 2.

259 Artificial Intelligence Act, art. 57, EUR. PARL. DOC. TA 138 (2024).

260 *Adequacy decisions*, *supra* note 228.

rightly left to the devices of individual Member States.[261] To that end, each Member State must develop a strategy of how many and which types of AI sandboxes to create, a decision for which the earlier discussion on the structure of AI sandboxes will be particularly relevant. Ultimately, developing a successful AI strategy at the national level will likely require a degree of experimentation, which is why national governments might benefit from launching pilot sandboxes during the transition period of the AI Act.[262]

Second, given the benefits of a general AI sandbox combined with multiple sector-specific AI sandboxes, that is likely the most sensible approach for at least major Member States like France, Germany, and Spain. Alternatively, EU countries could also group together and create sector-specific AI sandboxes open to any companies from participating nations.[263] This approach can also work for smaller countries, although some jurisdictions might instead prefer creating fewer sector-specific sandboxes focused on industries where they have a comparative advantage. However, smaller Member States might also have the option of joining the AI sandbox of another EU country (or a group of countries), including sector-specific sandboxes.[264] Further, national governments could still launch thematic sandboxes aimed at specific sectors within the framework of the broader AI sandbox. Zurich's thematic sandboxes in areas ranging from drone-assisted maintenance to AI-enabled grading could also provide helpful insights in this regard.[265]

Third, although the AI Act imposes some requirements on Member States to document the regulatory learning from AI sandboxes through exit reports and annual reports, national governments might benefit from implementing more extensive evaluation mechanisms.[266] Therefore, individual EU countries should consider going beyond the formal requirement and analyze how different aspects of the EU's current framework affect companies and consumers through the sandbox. While individual EU governments do not have the power to waive or adjust EU regulations through the sandbox, the regulatory insights from national-level AI sandboxes could still form the basis for reform at the EU level. Such efforts could also provide the impetus for more rigorous regulatory review and evaluation processes through EU bodies, such as the European Artificial Intelligence Board and the European Artificial Intelligence Office.[267]

Finally, one disadvantage that EU-aligned sandboxes at the national level might face vis-à-vis their non-EU counterparts like Britain and Switzerland is the inability to provide regulatory relief from EU regulations.

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261 Artificial Intelligence Act, arts. 57(1)-(2), EUR. PARL. DOC. TA 138 (2024).
262 *Id.* at art. 57(1).
263 *Id.*
264 *Id.*
265 ZURICH CANTON, *supra* note 16.
266 Artificial Intelligence Act, arts. 57(7), (16), EUR. PARL. DOC. TA 138 (2024).
267 *Id.*

While national governments might not have the power to provide such regulatory relief, they can still provide regulatory advice on compliance with EU regulations, as is the case with the Norwegian AI sandbox.[268] Even without regulatory waivers, such advice could provide an attractive incentive for start-ups and larger companies to join the sandbox. Furthermore, EU governments can use other policy levers, such as fiscal incentives, to promote participation. Additional efforts through innovation hubs could further complement these incentives. The European Union has already developed the European Digital Innovation Hubs (EDIH) network, which is a step in the right direction.[269] Member States should consider taking steps to improve regional EDIHs as well as national hubs outside the EDIH framework. These programs could be especially helpful in raising awareness about technology-related business opportunities and simplifying business registration, tax filing, and immigration procedures. A combination of these efforts could help individual European countries mitigate the potential disadvantages of the EU's sandbox strategy while advocating broader reforms at the EU level as needed.

J. *Additional Considerations for Emerging-Market Countries*

Several jurisdictions outside the United States and Europe—such as Brazil, Chile, and Colombia—are currently exploring ways to create artificial intelligence sandbox programs.[270] While best practices for designing AI sandboxes in the United States and Europe are broadly applicable, emerging-market countries could also face specific challenges that require special attention. However, since the term "emerging-market countries" encompasses countries as heterogeneous as Belarus, Indonesia, and Mexico, precise policy recommendations must be tailored to each country's political, economic, and legal contexts.

First, the analysis of the AI sandbox programs in this Article suggests that, while general principles exist, there is no one-size-fits-all formula for designing AI sandboxes that apply to all countries. Even within relatively similarly situated jurisdictions, such as Norway and Switzerland, the regulatory design of AI sandboxes can vary considerably. Instead of replicating the approach of a particular country wholesale, a more effective strategy would entail selectively borrowing elements from multiple jurisdictions that align best with the policy objectives and regulatory context of a specific country.

Second, while the growing availability of boilerplate legal templates makes formally creating a sandbox relatively easy, attracting quality applicants and implementing policy reforms based on sandbox data pose greater challenges for most jurisdictions. While this Article recommends the creation of innovation hubs to complement the efforts of AI sandboxes, such hubs are

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268 Note that Norway is a member of the European Economic Area, not the European Union.

269 *European Digital Innovation Hubs*, *supra* note 220.

270 GOV'T OF BRAZIL, *supra* note 80; UNESCO, *supra* note 188; *see also MinTic*, *supra* note 188.

especially crucial for emerging-market nations with technological ambitions. Well-designed sandboxes in the UK and Singapore, owing to their global reputation, will likely attract a steady stream of applicants because of their global reputation. However, for emerging-market nations that are less known internationally, it is paramount to engage in outreach efforts through innovation hubs and overseas investment offices. To that end, fintech innovation hubs of Estonia, Hong Kong, Singapore, and other innovative jurisdictions offer valuable models that merit closer examination.

Third, it is also important to consider the potential negative effects of sandboxes and implement preventive measures to mitigate such risks. For example, launching an ambitious AI sandbox program without establishing adequate privacy protection and consumer protection rules could result in the misuse of sensitive personal data and consumer harm. Because of such risks, jurisdictions such as the European Union are indeed correct in emphasizing the importance of data protection and informed consent in the context of AI sandboxes.[271] Such measures are even more important in the context of emerging markets, where structural weaknesses in the broader regulatory environment and legal system can exacerbate these risks. Questionable data protection practices could result in significant privacy violations and reputational damage, especially if foreign companies and consumers are implicated in those cases. That is why jurisdictions need to think more broadly about their broader technology ecosystem and take steps to improve the overall legal and regulatory frameworks when designing sandbox programs.

Finally, governments in emerging-market countries should take particular care to address potential challenges such as regulatory privilege and market distortion associated with regulatory sandboxes. While these risks also exist in developed economies, they are particularly pronounced in countries with recent histories of corruption and weak rule of law. Without establishing evidence-based criteria for eligibility and selection, adequate consumer safeguards, and mechanisms to evaluate regulatory lessons, it would be challenging to benefit properly from sandboxes. Likewise, while a well-designed sandbox might provide useful regulatory insights and foster innovation, other counterproductive policies—such as business-unfriendly tax policies, weak judicial systems, and bias against foreign companies—could counteract any marginal positive effects from a sandbox. Therefore, well-designed AI sandboxes must be complemented by other policy measures crucial for economic growth and innovation.

CONCLUSION

In his insightful lectures and scholarly works, Lord Jonathan Sumption, the distinguished English jurist and historian, questions the limits of law as a

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[271] Artificial Intelligence Act, arts. 57-58, EUR. PARL. DOC. TA 138 (2024).

social and political instrument.[272] His analysis is helpful in understanding these limits: a growing number of litigations, for example, may signify not only a well-functioning legal system but also a broader weakening of social order and norms. While less profound a line of inquiry, it is similarly beneficial to question the role of regulatory sandboxes. What, after all, is the purpose of regulatory sandboxes, and what are their limits in the context of AI regulation? A clearer sense of their regulatory functions and limits can be instrumental in designing sandboxes that more accurately reflect a particular jurisdiction's policy objectives and help avoid potential regulatory missteps.

At their best, regulatory sandboxes can promote technological innovation by attracting innovative companies and helping policymakers design an evidence-based, iterative approach to regulating emerging technologies. Where there are no innovative products or services, a regulatory sandbox cannot produce them out of thin air; however, a carefully designed sandbox can provide a platform that allows companies to test and bring innovative products to market more quickly while enabling regulators to craft better rules.

Now that it has been about eight years since the FCA launched the world's first regulatory sandbox in 2016, it is worth taking stock of the sandbox as a policy instrument.[273] From the FCA's fintech sandbox to Utah's legal sandbox, well-designed regulatory sandboxes have been effective in helping companies develop new products, promoting innovation, and inspiring other jurisdictions to do so. However, notwithstanding the growing number of regulatory sandboxes, it would be a mistake to conclude that they all have been equally effective. The more pertinent question is not whether a jurisdiction established a sandbox but *how* it was designed and implemented. As remains the case for fintech sandboxes, regulatory design will be critical to the long-term effectiveness of AI sandboxes.

Beyond regulatory design, are there specific sectors that are particularly well-suited for the introduction of a regulatory sandbox? While the right answer varies by jurisdiction, a general observation is that regulatory sandboxes can be particularly effective in rapidly changing industries, where supervised experimentation can allow new products and services to be offered more quickly and regulations calibrated. It is worth recalling that the most prominent U.S. sandbox has been in legal services, not insurance or financial services. At a time when more than 90 percent of Americans have inadequate access to legal services, legal sandboxes like Utah's have great potential to expand access to justice.[274] Moreover, recent advances in generative AI have expanded the range of industries that could benefit from well-designed

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[272] *See, e.g.*, Lord Jonathan Sumption, Lord Sumption gives the 27th Sultan Azlan Shah Lecture, Kuala Lumpur: The Limits of Law, Nov. 20, 20213, https://www.supremecourt.uk/docs/speech-131120.pdf; *see also* LORD JONATHAN SUMPTION, *LAW IN A TIME OF CRISIS* (2011).

[273] *Regulatory Sandbox*, FIN. CONDUCT AUTH., *supra* note 31.

[274] LEGAL SERVS. CORP., *supra* note 245, at 19; *Activity Report*, UTAH, *supra* note 13.

sandbox programs. Against this backdrop, the growing regulatory interest worldwide in creating general-purpose and sectoral AI sandboxes should be no surprise.[275]

Across the world, governments appear to face growing pressure to enact comprehensive AI legislation, which will likely increase as generative AI capabilities continue to evolve. While such pressure is understandable, prematurely enacting laws to regulate AI across various sectors without understanding their full regulatory implications can inhibit innovation while failing to address unforeseen AI safety and other risks.

Whether a jurisdiction seeks to enact comprehensive AI legislation or opts for a sector-specific approach, AI sandboxes can help chart an evidence-based, iterative path forward. On the one hand, for jurisdictions like the United Kingdom, which have opted against comprehensive AI legislation, regulatory sandboxes can help lawmakers and regulators identify statutory gaps and gradually introduce well-calibrated regulations and statutes accordingly.

On the other hand, for jurisdictions like the European Union, which are in the process of adopting comprehensive AI laws, regulatory sandboxes can also serve as a tool for course correction. If certain AI regulations are suboptimal, as might be the case with specific aspects of the EU's AI Act, regulatory insights from sandboxes could provide timely feedback. To that end, such jurisdictions must implement mechanisms to review regulatory lessons from sandboxes so that such insights can serve as the basis for regulatory adjustment and broader policy reform. That way, properly designed AI sandboxes could be an additional tool to help policymakers identify potential mistakes and recalibrate their approach if needed—without prolonging the adverse effects of poorly designed regulations in rapidly evolving sectors.

APPENDIX

Table A1. Selection and Evaluation Criteria for the Zurich Artificial Intelligence Sandbox[276]

Criteria and Description (Original)	Criteria and Description (English)
1) Testreife. Reifegrad des KI-Vorhabens zur konkreten Umsetzung.	1) Testing maturity. Maturity of the proposed AI project for concrete implementation.

[275] For example, U.K. DEP'T FOR SCI., *supra* note 17, at ¶¶ 95–98, n.142; *see also* GOV'T OF NORWAY, *supra* note 138; Artificial Intelligence Act, art. 53, EUR. PARL. DOC. TA 138 (2024).

[276] Each application receives an evaluation of "Sehr tief" (very low), "Tief" (low), "Mittel" (medium/average), "Hoch" (high), and "Sehr hoch" (very high) from the regulatory body. The minimum score required for selection is not discloser by Swiss regulatory authorities.

2) Regulierung. Potential für den Aufbau von regulatorischem Know-how.	2) Regulation. Potential to develop regulatory expertise.
3) Datennutzung. Potential für die Nutzung von schwer zugänglichen Datenquellen.	3) Data use. Potential for using data sources that are difficult to access.
4) Gesellschaftlicher Mehrwert. Potential für Bereitstellung von Diensten im öffentlichen Interesse.	4) Social value. Potential for providing services in the public interest.
5) Innovationsstandort. Potential für die Stärkung des Innovationsstandorts durch Differenzierung von herkömmlichen KI-Lösungen.	5) Innovation hub. Potential strengthening of the innovation hub through differentiation from conventional AI solutions.
6) Übertragbarkeit. Potential, die Ergebnisse auf weitere KI-Vorhaben in Wirtschaft, Verwaltung oder Forschung zu übertragen.	6) Transferability. Potential to apply the results [from the sandbox] to AI projects in business, administration, and research.
7) Technologische Ansätze. Potential für den Einsatz von innovativen technolog. [technologische] Ansätzen (bspw. Privacy-Enhancing-Technologies).	7) Technological approaches. Potential for innovative technological solutions (e.g., privacy-enhancing technologies).
8) Relevanz für Verwaltung. Relevanz der Ergebnisse für Kantone, Städte und Gemeinden im Metropolitanraum ZH.	8) Relevance for public administration. Importance of the [project's] outcomes for the Zurich metropolitan area's cantons, cities, and communities.
9) Notwendigkeit. Notwendigkeit für eine Teilnahme an der Sandbox.	9) Necessity. Necessity for participation in the sandbox.
10) Technische Umsetzbarkeit. Umsetzbarkeit aufgrund der technischen Anforderungen (bspw. Infrastruktur, Datenaustausch, Modellierung, etc.)	10) Technical feasibility. Feasibility of technical requirements (e.g., infrastructure, data transfer, modeling).
11) Nicht-technische Umsetzbarkeit. Umsetzbarkeit aufgrund der nicht-technischen Anforderungen (bspw. Datenzugang, politische Kritikalität).	11) Non-technical feasibility. Feasibility of non-technological requirements (e.g., data access, political sensitivity).

Source: Office for Economy and Labor, Canton of Zürich (2022); author's translation[277]

Table A2. Selection and Evaluation Criteria of the Spanish Government's EU-Aligned AI Sandbox[278]

Criteria and Description (Original)	Criteria and Description (English)
a) Grado de innovación o complejidad tecnológica del producto o servicio.	a) Degree of innovation or technological complexity of the [proposed] product or service.
b) Grado de impacto social, empresarial o de interés público que presenta el sistema de inteligencia artificial propuesto.	b) Degree of the potential social and commercial impact and the public interest benefits of the proposed AI system.
c) Grado de explicabilidad y transparencia del algoritmo incluido en el sistema de inteligencia artificial presentado.	c) Degree of explainability and algorithmic transparency of the proposed AI system.
d) Alineamiento de la entidad y el sistema de inteligencia artificial con la Carta de Derechos Digitales del Gobierno de España.	d) Alignment of the entity and proposed AI system with the Charter of Digital Rights of the Spanish government.
e) Tipología de alto riesgo del sistema de inteligencia artificial, buscando una representación variada de tipologías en la selección.	e) High-risk classification of the AI system [according to the EU's AI Act], seeking a variety of risk classifications in the selection [of AI sandbox projects].
f) Cuando se trate de sistemas de inteligencia artificial de propósito general, se evaluará también su potencial de ser transformados en un sistema de inteligencia artificial de alto riesgo.	f) In the case of general-purpose AI systems, the [proposed project's] potential to be transformed into a high-risk AI system will also be evaluated.
g) Cuando se trate de modelos fundacionales de inteligencia artificial se evaluará la capacidad de despliegue y utilización, así como el impacto relativo o absoluto en la economía y sociedad.	g) In the case of foundational AI models, the capacity for deployment and utilization and the relative or absolute impact on the economy and society will be evaluated.
h) El grado de madurez del sistema de inteligencia artificial, considerando que ha de estar lo suficientemente avanzado como para ser puesto en servicio o en el mercado	h) The degree of market-readiness of the AI system, considering that it must be sufficiently advanced to be put into service or on the market within the time frame of the

277 Amt für Wirtschaft und Arbeit, *supra* note 206.

278 ROYAL DECREE 817/2023, *supra* note 28, art. 8(2); author's translation.

en el marco temporal del entorno controlado de pruebas o a su finalización. Se buscará una representación variada de madurez de los sistemas de inteligencia artificial.	controlled test environment or following its completion. AI systems with varying levels of market-readiness levels will be sought [during the selection process].
i) La calidad de la memoria técnica.	i) The quality of the [accompanying] technical report.
j) El tamaño o tipología del proveedor IA solicitante, según número de trabajadores o volumen de negocios anual, valorándose positivamente la condición de empresa emergente, pequeña o mediana empresa para garantizar una mayor diversidad de tipologías de empresas participantes. Se buscará una representación variada de tamaño y tipología de proveedor IA en la selección.	j) The size or type of the applicant AI provider, according to the number of employees or annual turnover, with start-ups and small and medium-sized enterprises being favored to ensure a better representation of the types of participating companies. A varied representation, with respect to the size and type of AI providers, will be selected.
k) Y en su caso, la evaluación de la declaración responsable que acredite el cumplimiento de la norma relativa a la Protección de Datos Personales. De igual forma se podrá solicitar documentación acreditativa adicional según recoge el anexo V del presente real decreto.	a) And, where applicable, the evaluation of the statement accrediting the [project's] compliance with the Regulation on Personal Data Protection. Additional supporting documents may also be requested in accordance with Annex V of this Royal Decree.

LET'S MAKE A DEAL: HOW CLARIFYING THE FIDUCIARY DUTIES OF CONGRESS CAN HELP SOLVE THE ISSUE OF CONGRESSIONAL INSIDER TRADING

Alex Liubinskas

INTRODUCTION

Anyone tuning into the daily news probably comes away with the perception that Americans are more polarized across the political spectrum than ever. No matter what the issue of the day might be, it seems that Americans disagree sharply on the issues facing our Nation. However, there is one thing that most Americans can agree on: they perceive the government to be corrupt.[1] What is interesting about this perception is that it breaks the common "us versus them" mentality in partisan politics where the opposite party is described as immoral, incompetent, and unintelligent.[2] When it comes to corruption, everyone is implicated.

The perception of public servants being self-interested and corrupt is nothing new. During the Gilded Age, the halls of Congress were described as a "rich man's club" where Senate seats were auctioned off to the highest bidder and where political favors "were traded like horses."[3] More recently, studies conducted in 2011[4] and 2012[5] indicate that Americans perceive their

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1 A 2022 poll conducted in key battleground states reported that sixty-five percent of voters found corruption in government to be a "very big problem" facing the country—the highest mark reported in poll. Brandon Brockmyer, *Corruption is Public Enemy Number 1*, PROJECT ON GOV'T OVERSIGHT POLL (Oct. 7, 2021), https://www.pogo.org/analysis/corruption-is-public-enemy-number-1; Celinda Lake et al., *Findings Based on Focus Groups and An Online Survey Among Voter in Michigan and Ohio*, PROJECT ON GOV'T OVERSIGHT POLL (Sept. 2021), https://www.pogo.org/document/2021/10/findings-based-on-focus-groups-and-an-online-survey-among-voters-in-michigan-and-ohio. This outranks other prominent political issues such as crime and gun violence (sixty-three percent), COVID-19 (sixty-one percent), and climate change (forty-five percent). *Id.*

2 *As Partisan Hostility Grows, Signs of Frustration With the Two-Party System*, PEW RSCH. CNTR (Aug. 9, 2022), https://www.pewresearch.org/politics/2022/08/09/as-partisan-hostility-grows-signs-of-frustration-with-the-two-party-system/ (finding that partisans view the opposing party as "closed-minded, dishonest, immoral and unintelligent" than other Americans).

3 H.J. Sage, *Politics and Corruption in the Gilded Age, 1865–1900*, BREWMINATE BLOG (Oct. 28, 2022), https://brewminate.com/politics-and-corruption-in-the-gilded-age-1865-1900/.

4 In 2011, sixty-four percent of surveyed Americans gave the honestly and ethical standards of Congress a "very low" or "low" rating. *See* Jeffrey M. Jones, *Record 64% Rate Honesty, Ethics of Members of Congress Low*, GALLUP (Dec. 12, 2011), http://www.gallup.com/poll/151460/Record-Rate-Honesty-Ethics-Members-Congress-Law.aspx.

5 In a 2012 poll that measured the perceived ethical standards of twenty-two professions, members of Congress ranked the lowest with fifty-four percent of Americans giving Congress a rating of "very

Senators and Representatives to be corrupt and possess ethical standards lower than even other professions generally regarded as untrustworthy.[6] This perception is not unwarranted. American history is filled with accounts of public servants using nonpublic information to manipulate the stock market,[7] and the United States government is considered to be "'the largest producer of information capable of having a substantial effect on stock-market prices.'"[8]

The last fifty years are filled with accusations of congressional members using their positions on Capitol Hill to gain a competitive edge on the stock market. Just days before the 2008 market crash, multiple members of Congress sold large amounts of stocks, making a significant profit.[9] At the beginning of the COVID-19 pandemic and after being privately informed about the seriousness of the ensuing public health crisis, multiple members of Congress sold stocks at enormous profits.[10] In September of 2022, the New York Times published a report analyzing the trading activity of members of Congress and found that ninety-seven lawmakers bought or sold publicly traded assets in industries that could be affected by the lawmaker's legislative work.[11]

In 2012, Congress passed the STOCK Act in response to recent allegations of congressional members engaging in insider trading.[12] The Act was intended to solve the issue of congressional insider trading and provide a basis to which the Securities and Exchange Commission ("SEC") and

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low" or "low" for the honesty and ethical standards categories. *See* Frank Newport, *Congress Retains Low Honesty Rating*, GALLUP (Dec. 3, 2012), http://www.gallup.com/poll/159035/congress-retains-low-honesty-ratings.aspx.

6 *Id.* Member of Congress had lower ratings than car salespeople (forty-nine percent "very low" or "low") and stockbrokers (thirty-nine percent "very low" or "low").

7 For example, in 1778, Samuel Chase was impeached by the House for trying to use inside information to make money on the flour market. *See* Michael A. Perino, *A Scandalous Perversion of Trust: Modern Lessons From the Early History of Congressional Insider Trading*, 67 RUTGERS L. REV. 335, 339 (2015).

8 Paul D. Brachman, *Outlawing Honest Graft*, 16 N.Y.U. J. LEGIS. & PUB. POL'Y 261, 263 (2013) (quoting HENRY G. MANNE, INSIDER TRADING AND THE STOCK MKT. 171 (New York: The Free Press 1966)).

9 *See 60 Minutes: Congress: Trading Stock on Inside Information?* CBS NEWS (CBS television broadcast Nov. 13, 2011), http://www.cbsnews.com/8301-18560_162-57323527/congress-trading-stock-on-inside-information; Congress Cashes In On Insider Trading, REPRESENT US, https://represent.us/action/insider-trading/ (last visited Dec. 10, 2022).

10 *See* Dareh Gregorian, *Burr, Other Senators Under Fire for Stock Sell-Offs Amid Coronavirus Outbreak*, NBC NEWS (Mar. 20, 2020, 9:22 AM), https://www.nbcnews.com/politics/congress/aoc-calls-senate-intel-chair-richard-burr-resign-stock-selloff-n1164401.

11 Kate Kelly, et al., *Despite Their Influence and Extensive Access to Information, Members of Congress Can Buy and Sell Stocks With Few Restrictions*, N.Y. TIMES (Sept. 13, 2022), https://www.nytimes.com/interactive/2022/09/13/us/politics/congress-stock-trading-investigation.html.

12 *See* Kristen Kelbon, *Creating an Effective Vaccine to Prevent Congressional Insider Trading: Legislation is Needed to Cure Deficiencies of the STOCK Act*, 55 CREIGHTON L. REV. 145, 147–48.

Department of Justice ("DOJ") could investigate and prosecute members of Congress for insider trading. However, the STOCK Act has fallen short. And the DOJ and the SEC have failed to prosecute any member of Congress for insider trading under the Act.[13]

This Article aims to explain why the STOCK Act has failed to work as intended and offer a solution. The Act is ineffective for two main reasons. Despite the Act purporting to establish that members of Congress owe a fiduciary duty and violate that duty when they engage in insider trading, ambiguity arises when specifying the duty and applying it to an insider trading cause of action. Second, the Speech or Debate Clause of the Constitution and its broad interpretation by courts virtually bars the ability of the SEC or DOJ to collect evidence against members of Congress for alleged instances of insider trading. I argue that the proper framework for understanding the underlying fiduciary duty that members of Congress owe under the STOCK Act is to Congress itself. Further, I use analogical reasoning to argue that the relationship between Congress and its individual members is similar to the fiduciary relationship between partners in a partnership and the partnership itself. This interpretation has two advantages. First, it provides courts and regulators with a clear basis for applying traditional fiduciary principals to members of Congress. Second, this interpretation, and its grounding in partnership law, supports an argument that Congress should waive the evidentiary privileges that they enjoy under the Speech or Debate Clause by instituting internal mechanisms for investigating members of insider trading.

Part I of this Article outlines the required elements of an insider trading cause of action while focusing specifically on the most important element: breach of fiduciary (or fiduciary-like duty). Part II discusses the passage of the STOCK Act, its effectiveness, and the problems associated with it. Here, I argue that the STOCK Act leaves open questions about the fiduciary duty element in the context of congressional insider trading and that courts could have issues applying the STOCK Act's framework without clarification. I also argue that the Speech or Debate Clause prevents federal investigators from collecting evidence on congressional insider trading, making a successful investigation nearly impossible. In Part III I argue that the proper understanding of the fiduciary duty owed by members of Congress under the STOCK Act is to Congress as an institution and how this understanding clarifies the obligations individual members of Congress owe. Part IV explains how this framework supports the ability of Congress to institute internal investigations and waive the evidentiary privileges members of Congress enjoy under the Speech or Debate Clause.

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13 *See id.* at 164 n.129 ("[N]either the SEC nor the DOJ has prosecuted a member of Congress under the STOCK Act since its passage" even though at least 54 legislators have allegedly violated the STOCK Act by failing to report their securities trades).

I. THE INSIDER TRADING CAUSE OF ACTION

A. *Introduction to Insider Trading*

After the stock market crashed in 1929 triggering the Great Depression, Congress sought to pass legislation that would better regulate securities in the stock market and assure a more open and orderly market.[14] In 1934, Congress passed the Securities and Exchange Act of 1934 ("Exchange Act").[15] Under section 10(b) of the Act, it is illegal for any person selling or buying securities "[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance."[16] Under the regulatory authority granted to them by the Exchange Act, the SEC promulgated Rule 10b-5, which states that no person may "employ any device, scheme, or artifice to defraud . . . or . . . engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."[17] Although neither section 10(b) nor Rule 10b-5 mention "insider trading" courts and administrative agencies have interpreted these provisions to provide the basis for insider trading liability.[18]

B. *Elements Of Insider Trading*

While section 10(b) and Rule 10b-5 provided the underlying authority to prosecute insider trading, the elements of the claim have been developed by the courts.[19] Generally, there are four elements to an insider trading cause of action: (1) trading on (or tipping); (2) material; (3) nonpublic information; (4) in breach of fiduciary (or fiduciary-like) duty.[20] The following section provides a summary of the elements. The first three elements have little issue being applied to the context of congressional insider trading. However, the

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[14] H.R. REP. NO. 94-229, at 91–92 (1975) (Conf. Rep.) (Congress observed in 1975 that the basic goals of the Exchange Act were to assure: fair mechanisms for pricing securities, the dealing of securities is fair without undue special treatment to some investors, that securities can be bought and sold efficiently, and the markets are free and open.).

[15] 15 U.S.C. § 78a (1934).

[16] 15 U.S.C. § 78j(b) (1934).

[17] 17 C.F.R. § 240.10b–5 (2012).

[18] *See, e.g.*, United States v. O'Hagan, 521 U.S. 642, 651–56 (1997) (affirming that insider trading liability arises under Section 10(b) and the various theories of liability).

[19] *See* Sung Hui Kim, *The Last Temptation of Congress: Legislator Insider Trading and the Fiduciary Norm Against Corruption*, 98 CORNELL L. REV. 845, 854–55 (2013) (noting that the elements of insider trading have largely been judicially manufactured).

[20] *Id.* at 855 (outlining the elements of an insider trading cause of action).

fourth element requires an understanding of the various theories of insider trading liability and will be analyzed independently.

1. Trading on (or Tipping) Requirement

In order to sustain an insider trading cause of action, the first element that the prosecution must prove is that the defendant traded (or tipped) based on the information in question. This requires proving that the defendant possessed material, nonpublic information at the time they traded the security and had the requisite scienter (state of mind).[21] Once possession is established, courts generally infer that the defendant used the material, nonpublic information to exploit an informational advantage on the marketplace.[22] This inference typically establishes the required scienter to sustain insider trading liability.[23]

If the suit is civil, the scienter required to sustain an action requires evidence that the "defendant knew that the information was material and nonpublic or recklessly disregarded facts that would indicate that the information in his possession was material and nonpublic."[24] If the suit is criminal, the defendant must have "willfully" engaged in impermissible insider trading.[25] Willfully requires a showing of a "realization on the defendant's part that he was doing a wrongful act . . . and that the knowingly wrongful act involved a significant risk of effecting the violation that occurred."[26] There are cases where the defendant has argued that the inside information was not a significant factor in their decision to trade the security, such as where the defendant was compelled by a personal circumstance to trade the security or that they would have traded it regardless of the information.[27] If the defendant can prove that the trade occurred independent of the nonpublic information, courts may not find liability depending on the jurisdiction.[28] Besides evidentiary hurtles that arise from the Speech or Debate Clause, how this element

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21 *Id.* at 856; *see, e.g.*, SEC v. Adler, 137 F.3d 1325, 1340 (11th Cir. 1998) ("Scienter necessarily requires that the insider have possession of material nonpublic information at the time the insider trades.").

22 DONALD C. LANGEVOORT, INSIDER TRADING: REGUL., ENF'T & PREVENTION § 3:13 (2022).

23 *Adler*, 137 F.3d at 1340; Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976).

24 LANGEVOORT, *supra* note 22, at § 5:5.

25 *Id.* at § 8:13 (noting that the Exchange Act as amended in by the Sarbanes Oxley Act of 2022, provides criminal convictions to individuals who "willfully" violate any provision of the Exchange Act).

26 *Id.*

27 *Id.* at § 3:13. The case law on whether the defendant can strike down an insider trading case by arguing that the inside information was not a significant factor in their decision to trade is inconsistent. The Second Circuit has determined that possession alone is sufficient to establish scienter. *See* U.S. v. Teicher, 987 F.2d 112, 120 (2d Cir. 1993). Others, such as the Eleventh Circuit, have determined that possession raises a rebuttable inference that the defendant used the information to trade. *Adler*, 137 F.3d at 1340.

28 Kim, *supra* note 19, at 857.

is analyzed is not significantly altered just because a defendant is a member of Congress.[29]

2. Materiality Requirement

The analysis of the second element—that the information be material—does not substantially change if the defendant happens to be a Representative or Senator. Information is material "if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision."[30] Importantly, certainty of a particular outcome is not necessary for information to be material.[31] Instead, "the information need not be such that a reasonable investor would necessarily change his investment decision on the information, as long as a reasonable investor would have viewed it as significantly altering the total mix of information."[32]

In regards to contingent information, materiality is determined by "a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity."[33] For the purposes of sustaining an action against a member of Congress for trading on the basis of anticipated legislative events, "the factfinder must assess the likelihood (at the time of the trade) that the legislative event would come to pass and the importance of the event to an issuer's business (at the time of the trade)."[34]

Although many legislative developments are difficult to predict due to the uncertainty and volatility of the legislative process, asserting that a legislator traded on material information is not as burdensome as one would think.[35] First, the very fact that the defendant traded on the information can support a finding of materiality.[36] If a judge or jury is persuaded that the information in question factored into the defendant's decision to buy or sell the security, and it believes that the defendant was a "reasonable" investor, then

29 *Id.*. For a discussion of the evidentiary burdens placed on investigators, see section II(C)(1).

30 TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976).

31 LANGEVOORT, *supra* note 22, at § 5:5.

32 *Id.* at § 5:2 (quoting SEC v. Mayhew, 121 F.3d 44, 52 (2d Cir. 1997)).

33 Basic Inc. v. Levinson, 485 U.S. 224, 238 (1988) (quoting SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968) (en banc)). Information can be considered material even when the trader risked that their trade might not result in a profitable return on their investment. For example, in an administrative proceeding before the SEC, information obtained from a drilling company indicated that there was some oil in a geographical area was material even though there was only a twenty-five percent chance of future profitable operations. *See* LANGEVOORT, *supra* note 22, at § 5:2 (citing In re Wentz, Sec. L. Rep. (CCH) ¶ 83, 629 (Admin. Proc. May 15, 1984)).

34 Kim, *supra* note 19, at 857.

35 *Id.*

36 LANGEVOORT, *supra* note 22, at § 5:2; *see, e.g.*, SEC v. Shared Med. Sys. Corp., No. CIV.A 91-6546, 1994 WL 201858, at *2 ("trading by an insider in suspicious amounts or at suspicious times" raises an inference of materiality).

materiality can be sustained because the information presumably altered the "total mix of information."[37] Second, evidence of a major market movement prompted by the passage of a legislative act could support a finding of materiality.[38] Just like the first element, the analysis of materiality does not alter significantly just because the defendant happens to be a member of Congress. However, investigators and prosecutors will probably have issues collecting the material information in question because the information most likely derived from legislative business and thereby will be privileged under the Speech or Debate Clause.[39]

3. Nonpublic Information Requirement

The third element of an insider trading cause of action requires that the information in question be "nonpublic" meaning it is not generally available to the public and has not been broadly disseminated.[40] In a typical insider trading case, whether information is "nonpublic" is rarely contested.[41] Stock markets are presumed to be efficient, and once information is disseminated to a large number of market participants, the market price of the security quickly resembles the impact of that information to the value of the security.[42] Once the market has internalized the information, the information is said to be public,[43] and the ability for an insider to generate profits from the information is extinguished.[44] However, prior to internalization of the information by the market, the information is likely considered nonpublic for the purposes of sustaining a claim.[45]

Senators and Representatives have ample opportunities to access nonpublic information. For example, legislators through their subpoena power may access a publicly traded company's inside information through the course of a legislative investigation or could easily gain access to how a security may be traded in the future through their knowledge of a proposed legislative action, anticipated criminal investigation, or anticipated agency regulation that may impact an entire industry.[46]

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37 *Id*.

38 Kim, *supra* note 19, at 858.

39 See section II(C)(1) for a discussion of material information being privileged under the Speech or Debate Clause and therefore unavailable to investigators.

40 LANGEVOORT, *supra* note 22, at § 5:4 (citing SEC v. Matthew, 121 F.3d 44, 50 (2d Cir. 1997)).

41 *Id.*

42 *Id.*

43 *See, e.g.*, United States v. Libera, 989 F.2d 596, 601 (2d Cir. 1993).

44 LANGEVOORT, *supra* note 22, at § 5:4.

45 *Id.*

46 Kim, *supra* note 19, at 859.

C. *Breach of Fiduciary Duty Requirement*

In order to determine whether a fiduciary duty exists, and whether the defendant breached their fiduciary duty when they traded on material, nonpublic information, requires a factfinder to distinguish between four different theories of insider trading lability: (1) the "classical" theory; (2) the "tipper-tippee" theory; (3) the "constructive" theory; and (4) the "misappropriation" theory.[47] Without a requisite fiduciary duty, a defendant cannot be liable for trading on material, nonpublic information. As discussed in the previous section, a defendant will be found liable for insider trading under all four theories if the defendant (1) traded (or tipped) a security on (2) material, (3) nonpublic information (4) in breach of a fiduciary (or fiduciary-like) duty. The tipper-tippee and constructive theories are outgrowths of the classical theory of insider trading and will be discussed first, followed by a summary of the misappropriation theory.

1. The Classical, Tipper-Tippee, and Constructive Theories of Insider Trading

The "classical" theory of insider trading is conceptually the simplest: a corporate insider violates section 10(b) and Rule 10b-5 by using material, nonpublic information as the basis for trading a security in violation of their fiduciary duty owed to a corporation and its shareholders.[48] Under the "classical" theory, trading on this material, nonpublic information qualifies as a "deceptive device" under section 10(b) because "a relationship of trust and confidence [exists] between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation."[49] This relationship of trust and confidence between an corporate insider and the company to which they are an agent of, subjects the trader to a duty to disclose the material, nonpublic information prior to

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47 Kelbon, *supra* note 12, at 151–52. In 2009, the Second Circuit introduced a new theory of insider trading. *See* SEC v. Dorozhko, 574 F.3d 42, (2d Cir. 2009). In SEC v. Dorozhko, the Second Circuit held that for purposes of Section 10(b) and Rule 10(b), liability can be found without a fiduciary duty requirement in certain situations where the alleged fraud is an affirmative misrepresentation rather than a nondisclosure. *Id.* at 49. However, this case presented a unique situation where the defendant hacked into a corporation's computer system and traded on the information he obtained through the hack and has not been extended other situations. *Id.*; *see* Bradley J. Bondi & Steven D. Loftchie, *The Law of Insider Trading: Legal Theories, Common Defenses, and Best Practice for Ensuring Compliance*, 8 N.Y.U. J.L. & BUS. 151, 156–60 (2011).

48 *O'Hagan*, 521 U.S. at 651–52; *see* Aaron Kane, *Congressional Insider Trading Lives On: Not Even a Global Pandemic Could Stop It*, 15 ALBANY GOV. L. REV. 101, 103 (2022).

49 *O'Hagan*, 521 U.S. at 651–52 (quoting Chiarella v. United States, 445 U.S. 222, 228 (1980)).

trading.[50] Therefore, liability can only arise under the classical theory "when one party has information 'that the other [party] is entitled to know because of a fiduciary duty or other similar relation of trust and confidence between them.'"[51]

It is important to note that the term "similar relation of trust and confidence" suggests that relationships that are not strictly fiduciary as a matter of law but share common characteristics of a fiduciary relationship may also satisfy the requirements to sustain an insider trading cause of action.[52] Probably the best articulation of the fiduciary-like duty that arises from a relationship of trust and confidence comes from *United States v. Chestman*, where the Second Circuit stated that a "relationship of trust and confidence" must be one of "functional equivale[nce] of a fiduciary relationship" and "share the essential characteristics of a fiduciary association."[53]

In *Dirks v. SEC*, the Supreme Court expanded the classical theory in two important areas. First, the Court held that insider trading liability applies to the practice of tipping and trading on a tip under the "tipper-tippee theory."[54] The Court reasoned that a tipper, as a corporate insider privy to a company's nonpublic information, breaches their fiduciary duty of loyalty to the company when they disclose the information to a third party.[55] However, the Court noted not all discloses to third parties constitute a breach of the corporate insider's fiduciary duty.[56] Rather, the corporate insider must have received a personal benefit as a result of the disclosure in order for them to have breached their fiduciary duty.[57] Additionally, the Court reasoned that the tippee assumes the tipper's fiduciary duty of loyalty if (1) the tipper breached their duty of loyalty by sharing material nonpublic information with the tippee; (2) the tippee "knows or should have known that there has been a breach;" (3) the tippee uses the information to engage in a securities transaction; and (4) the tipper receives a personal benefit deriving from the tippee's securities transaction.[58] The personal benefit element of tippee/tipper insider trading liability has been interpreted to mean any "pecuniary gain or

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50 *Id.* at 652; Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties Into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV., 1189, 1194 (1995).

51 *Chiarella*, 445 U.S. at 228 (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(1) (1976)).

52 Kim, *supra* note 19, at 860–63.

53 United States v. Chestman, 947 F.2d 551, 568 (2d. Cir. 1991); *see* Jeanne L. Schroeder, *Taking Stock: Insider and Outsider Trading By Congress*, 5 WM. & MARY BUS. L. REV. 159, 189 (2014).

54 Dirks v. SEC, 463 U.S. 646, 660–62 (1983).

55 *Id.* at 647.

56 *Id.* at 662.

57 *Id.* (holding that an insider breaches their fiduciary duty when using the inside information to attain a personal benefit or gain).

58 *See generally*, *id.* at 659–61.

reputational benefit that will translate to future earnings,"[59] or when the exchange of information acted as a gift to a relative or close friend.[60] Therefore, if a member of Congress knowingly receives a tip from a corporate insider and the insider receives a personal benefit from the legislator, then the legislator assumes the insider's fiduciary duty and may not trade on the tip or further tip the information to a third party.[61]

Second, the Court in *Dirks* extended insider trading liability to "constructive insiders." Under the "constructive" theory, individuals such as attorneys, accountants, or consultants who temporarily enter into a confidential relationship with the corporation and are granted access to information normally reserved for corporate insiders are deemed insiders and assume a fiduciary duty if: (1) the corporation expects the outsider to keep the nonpublic information confidential; and (2) the constructive insider and the corporation are in a relationship that implies such a duty to keep the information confidential.[62] Therefore, if a congressional member is advising a corporation as a constructive insider (such as an consultant or attorney), then the fiduciary duty to disclose would uncontroversially apply to that member of Congress.[63]

Although the discussion of the requisite fiduciary duty under the classical theory is often thought to only apply to corporate insiders or constructive insiders, the Supreme Court in *Dirks* did not explicitly limit liability to only insiders or constructive insiders.[64] Instead, the Court reaffirmed the language first introduced in the Supreme Court's decision in *Chiarella* by noting that "there can be no duty to disclose where the person who has traded on inside information 'was not [the corporation's] agent, . . . was not a fiduciary, [or] was not a person in whom the sellers [of the securities] had placed their trust and confidence.'"[65] This categorized list suggests that "agents" and "fiduciaries" are not redundant categories under the classical or constructive insider theory and that a fiduciary-like duty may arise outside the confines of a traditional corporate insider relationship (if a relationship of trust and confidence exists that suggests a fiduciary-like duty).[66]

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59 *Id.* at 663; *see* Bondi & Loftchie, *supra* note 47, at 157–58 (finding that courts take a broad view of personal gain and have even found tippers liable for providing the information to the tippee in order to maintain networking contacts and friendships).

60 Salman v. United States, 137 S. Ct. 420, 429 (2016) (citing United States v. Salman, 792 F.3d 1087, 1093–94 (9th Cir. 2015)).

61 Kim, *supra* note 19, at 862.

62 *O'Hagan*, 521 U.S. at 651–52 (1997) (citing *Dirks*, 463 U.S. at 655, n.14).

63 Kim, *supra* note 19, at 862.

64 *Id.* at 863.

65 *Dirks*, 463 U.S. at 654 (alternations in original) (quoting *Chiarella*, 445 U.S. at 232).

66 Kim, *supra* note 19, at 863.

2. The Misappropriation Theory of Insider Trading

The alternative to the "classical" theory – and its expansion to tipper/tippee and constructive insiders in *Dirks* – is the "misappropriation theory." In resolving a circuit split, the Supreme Court first endorsed the misappropriation theory in *United States v. O'Hagan*.[67] This theory applies to situations where an individual, who is not a corporate insider within the meaning of the classical theory or its expansion in Dirk, comes into possession of material nonpublic information.[68] This outsider "commits fraud 'in connection with' a securities transaction . . . when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."[69] The alleged fraud under the misappropriation theory does not arise from a failure to disclose the inside information to purchasers and sellers of stock, but instead arises from a defendant's failure to disclose to the source of the information the defendant's intention to trade on the information.[70] The distinction between the misappropriation theory and the classical theory is subtle. Under the classical theory, liability for a corporate insider, constructive insider, or tipper/tippee is premised on a fiduciary relationship between the trader of the nonpublic information and a purchaser or seller of company stock.[71] Under the misappropriation theory, liability is premised on a trader's deception of those who entrusted him with access to the confidential information.[72] Because of the nature of the fiduciary relationship, the misappropriation theory is thought to be the primary source of liability for government insiders, although it is possible for government insiders to be liable under the classical theory.[73]

Importantly, the misappropriation theory still requires that there be an underlying fiduciary relationship between the defendant and the source of the information. Without such a relationship, there is no independent duty to observe another person's confidence or not profit off information received.[74] However, because the misappropriation theory allows for a relationship of confidentiality to exists outside the confines of insiders or constructive insiders, this theory implicates a larger number of relationships.[75] In establishing

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67 LANGEVOORT, *supra* note 22, at § 6:3.

68 *O'Hagan*, 521 U.S. at 652–53.

69 *Id*. at 652 (citing 15 U.S.C. § 78j(b) (1934)). The Court in *O'Hagan* pulls from Agency Law to assert that under the "misappropriation theory," a trader's self-serving use of the material nonpublic information belonging to its principal, defrauds the principal in violation of agent's fiduciary duty of loyalty and confidentiality. *See id.*

70 LANGEVOORT, *supra* note 22, at § 6:1; *see, e.g.*, *O'Hagan*, 521 U.S. at 652.

71 *O'Hagan*, 521 U.S. at 652.

72 *Id.*

73 LANGEVOORT, *supra* note 22, at § 6:4.

74 *Id.*

75 *Id.*

this fiduciary duty, the emphasis is usually on a duty of trust and confidence rather than a formal fiduciary status.[76] In an effort to clarify liability under the misappropriation theory, the SEC promulgated Rule 10b5-2.[77] 10b5-2 outlines three situations where a duty of "trust or confidence" arises: (1) whenever a person "agrees to maintain information in confidence;" (2) whenever parties maintain a "history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know" that the source expects the recipient to keep the information confidential; or (3) "[w]henever a person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling."[78] The misappropriation theory and the SEC's promulgation of 10b5-2 has broadened the situations where insider trading liability can be imposed. For example, a trader who has no connection to the financial markets and merely received information from a source who premised the exchange of the information on confidentiality can be liable for insider trading if they trade on such information.

Furthermore, the misappropriation theory provides a more straight-forward application to members of Congress. Unless congressional members have a role outside their positions in Congress, such as being on a board of a company or a consultant, they likely have no direct connection to the company's security they are trading on. Instead, their requisite fiduciary duty would lie with the source of the information, which I will argue later, is to Congress as a whole as well as to other members within Congress.

II. THE STOCK ACT AND ITS SHORTCOMINGS

Now that I have provided a basic outline of the insider trading cause of action under Rule 10b-5, I now turn my focus to the only piece of legislation explicitly aimed at combating legislator insider trading: the Stop Trading on Congressional Knowledge (STOCK) Act.[79] First, I will discuss the passage of the Act and its relevant language. I will then analyze the effectiveness of the Act at preventing congressional insider trading. Then, I will turn to the two main problems with the Act and how they thwart the effectiveness of the STOCK Act.

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[76] *Id.*

[77] 17 C.F.R. § 240.10b5-2 (2020); Thomas M. Madden, *O'Hagan, 10b-5-2, Relationships and Duties*, 4 HASTINGS BUS. L.J. 55, 70–72 (2008) ("The more recent action by the Commission to promulgate new Rules 10b5-1 and 10b5-2 was . . . an attempt to better define the circumstances where the misappropriation theory applies.").

[78] 17 C.F.R. § 240.10b5-2-2(b) (2011).

[79] Stop Trading on Congressional Knowledge Act of 2012, Pub. L. No. 112–105, 126 Stat. 291 [hereinafter STOCK Act].

A. *The Passage of the STOCK Act*

The STOCK Act was originally introduced by Representatives Louise Slaughter and Brian Baird in 2006 as a response to news reports of Representative Tom Delay's former Chief of Staff, Tony Rudy, buying and selling hundreds of stocks from his capitol office computer.[80] However, the STOCK Act remained idle in the House until 2011 when CBS "60 Minutes" ran a story accusing multiple members of Congress of trading on insider information to obtain significant profits.[81] Feeling public backlash from the 60 Minutes report, then President Obama called on Congress to pass the STOCK Act.[82] A few weeks later, the STOCK Act was passed by both Houses and signed into law in 2012.[83] The Act intended to subject members of Congress and their staff to the rules promulgated under SEC Rule 10b-5 and prohibited them from trading securities based on nonpublic knowledge obtained through their congressional capacity.[84] Specifically, the Act clarified that:

> [E]ach Member of Congress or employee of Congress owes a duty arising from a relationship of trust and confidence to the Congress, the United States Government, and the citizens of the United States with respect to material, nonpublic information derived from such person's position as a Member of Congress or employee of Congress or gained from the performance of such person's official responsibilities.[85]

It is important to note that the STOCK Act did not create any new theories of insider trading liability.[86] Rather, it was intended to incorporate the existing framework of insider trading, as understood by the Supreme Court and the SEC, to impose a fiduciary duty on members of Congress and their

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[80] H.R. 1148, 112th Cong. (2011); *see* Kelbon, *supra* note 12, at 161 & n.112. (citing Brody Mullins, *Bill Seeks to Ban Insider Trading By Lawmakers and Their Aides*, WALL ST. J. (Mar. 28, 2006), https://www.wsj.com/articles/SB114351554851509761).

[81] *See 60 Minutes*, *supra* note 9. The allegations primarily centered around several members of Congress pulling their money from stock market twelve days before the 2008 crash. *Id*. They did so after Congress had been informed by Treasury Department and the Federal Reserve of a looming economic crash. *Id*. The 60 Minutes investigation uncovered market imparity across the political spectrum from Republican Senator Shelley Capito to Democratic Representative Nancy Pelosi. *Id.*

[82] Kane, *supra* 48, at 105 (citing John Hudson, *Congress Doesn't Want to Give Up Its Insider Trading Privileges*, THE ATLANTIC (Jan. 25, 2012), https://www.theatlantic.com/politics/archive/2012/01/congress-doesnt-want-give- its-insider-trading-privileges/332676/ (quoting the portion of President Obama's State of the Union Address in which he asked Congress to "[s]end [him] a bill that bans insider trading by Members of Congress, and [he] will sign it tomorrow.")).

[83] STOCK ACT, Pub. L. No. 112–105, § 6, 126 Stat. 291, 292 (2012); Stephanie Condon, *Obama Signs STOCK Act to Ban "Congressional Insider Trading,"* CBS NEWS (Apr. 4, 2012, 12:47 PM), https://www.cbsnews.com/news/obama-signs-stock-act-to-ban-congressional-insider-trading/.

[84] Condon, *supra* note 83.

[85] STOCK ACT, Pub. L. No. 112–105 § 4(b)(2)(g)(1), 126 Stat. 291, 292 (2012).

[86] *See* Anna Fodor, *Congressional Arbitrage at the Executive's Expense: The Speech or Debate Clause and the Unenforceable Stock Act*, 108 NW. U. L. REV. 607, 627–28 (2014).

employees and reaffirmed that Congress and its staff are subject to the same civil and criminal insider trading laws that broadly apply to the public.[87] In a catchall sentence, the STOCK Act purports to affirm that members of Congress owe a fiduciary-like relationship of trust and confidence to Congress, the citizens of the United States, and the United States Government.[88] In doing so, the Act mimics the case law and Rule 10b-5 by asserting that legislators violate this duty when they trade on material, nonpublic information or when they act as a tippee.[89]

Importantly, despite significant public outcry against the perceived corruption of members of Congress during the passage of the Act, the final version of the bill was not as powerful as it could have been.[90] During floor deliberation, Senators Sherrod Brown and Jeff Merkley argued that an amendment should be added to the Act that would require members to sell securities that created conflicts of interest or place them in a blind trust.[91] Senator Brown argued that the perceived corruption implicated with owning interested securities reflected poorly on Congress and that more stringent action was necessary.[92] However, the amendment was struck down by seventy-three Senate members.[93]

Along with stating that members of Congress are subject to traditional insider trading laws, the STOCK Act increased the disclosure requirements for its members by requiring that members of Congress report their financial transactions within thirty days.[94] However, many members fail to meet this requirement, citing ignorance of law or clerical errors.[95]

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87 *See* Kelbon, *supra* note 12, at 162; *see also* Peter Rasmussen, *ANALYSIS: The Stock Act Still Works, but it Could Work Better*, BLOOMBERG L. (Aug. 4, 2020, 9:50 AM), https://news.bloomberglaw.com/bloomberg-law-analysis/analysis-the-stock-act-still-works-but-it-could-work-better-6 (finding that the STOCK Act affirmed that Congress was not exempt from insider trading liability).

88 STOCK ACT, Pub. L. No. 112–105, § 4(b)(2)(g)(1), 126 Stat. 291, 292 (2012).

89 *See* STEPHEN M. BAINBRIDGE, INSIDER TRADING LAW AND POLICY 112 (2014).

90 Kane, *supra* note 48, at 108.

91 *Merkley, Brown Outline Amendment That Would Strengthen Insider Trading Bill*, JEFF MERKLEY: PRESS RELEASE (Feb. 1, 2012), https://www.merkley.senate.gov/news/press-releases/merkley-brown-outline-amendment-that-would-strengthen-insider-trading-bill.

92 *See id.*

93 *See* Donna M. Nagy, *Owning Stock While Making Law: An Agency Problem and a Fiduciary Solution*, 48 WAKE FOREST L. REV. 567, 622 (2013).

94 STOCK ACT, Pub. L. No. 112–105, § 6(a), 126 Stat. 291, 293 (2012).

95 Dave Levinthal, *78 Members of Congress Have Violated a Law Designed to Stop Insider Trading and Prevent Conflicts-of-Interest*, BUSINESS INSIDER (Jan. 3, 2023), https://www.businessinsider.com/congress-stock-act-violations-senate-house-trading-2021-9#rep-peter-welch-a-democrat-from-vermont-5.

B. *Ineffectiveness of the STOCK Act at Combating Congressional Insider Trading*

Despite numerous accusations and investigations, neither the DOJ nor the SEC have prosecuted any members of Congress for insider trading since the passage of the STOCK Act.[96] In January of 2020, Representative Chris Collin was found guilty of tipping his son inside information and sentenced to twenty-six months in prison.[97] Although the STOCK Act might have helped draw awareness to Collin's trading activities, the information he tipped to his son was acquired by Collins through his position on a company's board, not from his role as a Representative.[98]

The issue of congressional insider trading came to the forefront of public discourse during the COVID-19 pandemic.[99] During the early stages of the pandemic, when the federal government was largely downplaying the threat of the virus to the public,[100] multiple Senators, their families, and aids sold a considerable number of stock.[101] The Senators included members of both parties such as Richard Burr, Dianne Feinstein, Kelly Loeffler, and James Inhofe.[102] They sold these stocks before the public and more importantly, the market, had any inclination of the seriousness of the ensuing pandemic.[103]After these stocks were sold and it became clear that COVID-19 was going to have a serious effect on the economy, the New York Stock Exchange experienced volatility.[104] The lucky Senators and aids who sold their stocks prior to the volatility experienced profits in the millions of dollars.[105]

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96 *See* Kelbon, *supra* note 12, at 164 n.129 (federal law enforcement agencies have rarely used the STOCK Act and that at least 54 legislators have allegedly violated the STOCK Act by failing to report their securities trades); *see also* Levinthal, *supra* note 95.

97 *See* Caroline Kelly & Sheena Jones, *Former Rep. Chris Collins, the First Member of Congress to Endorse Trump, Sentenced to 26 Months in Prison in Insider Trading Case*, CNN (Jan. 18, 2020, 1:16 PM), https://www.cnn.com/2020/01/17/politics/collins-sentencing/index.html.

98 *See* Erica Orden, *Former Rep. Chris Collins Pleads Guilty to Federal Crimes*, CNN POL. (Oct. 1, 2019), https://www.cnn.com/2019/10/01/politics/chris-collins-guilty-plea/index.html (finding Representative Collins gave his son nonpublic information regarding the results of a drug trial conducted by a company who Collins was a board member of).

99 *See* Gregorian, *supra* note 10.

100 *See, e.g.*, Kathryn Watson, *A Timeline of What Trump Has Said on Coronavirus*, CBS NEWS (Apr. 3, 2020, 6:35 PM), https://www.cbsnews.com/news/timeline-president-donald-trump-changing-statements-on-coronavirus/.

101 *See* Gregorian, *supra* note 10.

102 *Id.*

103 *Id.*

104 *See* Taylor Telford & Thomas Heath, *U.S. Stocks Nosedive, Trading Paused as Emergency Fed Action Fails to Mollify Investors*, THE WASH. POST (Mar. 16, 2020, 3:19 PM), https://www.washingtonpost.com/business/2020/03/16/stocks-markets-live-updates-coronavirus/.

105 *See* David Shortell, et al., *Exclusive: Justice Department Reviews Stock Trades by Lawmakers After Coronavirus Briefings*, CNN POL. (Mar. 30, 2020, 10:22 AM), https://www.cnn.com/2020/03/29/politics/justice-stock-trades-lawmakers-coronavirus/index.html

When news of these trades by the Senators and their aids came to light, there was considerable bipartisan outrage.[106] The FBI opened an investigation into all four Senators.[107] However, Senators Feinstein, Loeffler, and Inhofe were all quickly cleared.[108] Under intense media pressure, Senator Burr resigned from his Chair position on the Senate Intelligence Committee,[109] but the investigation into his actions was eventually dropped as well.[110]

Congressional insider trading continues to be in the news. In September of 2022, the New York Times published a report that analyzed the trading activity of Senators and Representatives and found that 97 lawmakers (or their family members) bought or sold publicly traded assets in industries that could be affected by the lawmaker's legislative committee work.[111] For example, the report found that the wife of Representative Alan Lowenthal sold a large number of Boeing shares on March 5, 2020, which was just one day before a House committee on which Representative Lowenthal sits, released their preliminary finding into Boeing's mishandling of its production of their 737 Max jet.[112]

C. *Problems With the STOCK Act*

Why has not a single member of Congress been charged, nevertheless convicted, of insider trading under the STOCK Act despite numerous reliable accusations and multiple investigations? The answer lies with the two major hurtles that prosecutors must overcome to successfully assert an insider trading cause of action under the STOCK Act. First, although the STOCK Act

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(discussing a few examples, including one Senator making between $628,000 and $1.7 million from selling their stocks and another making between $1.275 million and $3.1 million on stock deals).

106 *See* Katie Shepherd, *'There is No Greater Moral Crime': Tucker Carlson Calls for Sen. Richard Burr's Resignation Over Stock Sell-Off*, WASH. POST (Mar. 20, 2020, 9:40 AM), https://www.washingtonpost.com/nation/2020/03/20/coronavirus-tucker-carlson-burr/.

107 Dan Mangan, *DOJ Still Investigating Coronavirus Stock Sales by Sen. Burr, but Drops Probes of Loeffler, Inhofe, Feinstein*, CNBC (May 27, 2020, 8:17 AM), https://www.cnbc.com/2020/05/26/coronavirus-doj-investigates-burr-stock-sales-drops-loeffler-feinstein-probes.html.

108 *Id.*

109 Jeremy Herb et al., *Richard Burr to Step Down as Intelligence Committee Chairman*, CNN POL. (May 14, 2020, 3:09 PM), https://www.cnn.com/2020/05/14/politics/richard-burr-steps-down-intel-chairman/index.html.

110 Evan Perez & Paul LeBlanc, *DOJ Closes Insider Trading Investigation Into Sen. Richard Burr*, CNN POL. (Jan. 19, 2021, 9:28 PM), https://www.cnn.com/2021/01/19/politics/doj-insider-training-investigations-closed/index.html.

111 Kelly, et al., *supra* note 11.

112 *Id.*; House Committee on Transportation & Infrastructure, *The Boeing 737 MAX Aircraft: Preliminary Investigative Findings* (March 2020), https://transportation.house.gov/imo/media/doc/TI%20Preliminary%20Investigative%20Findings%20Boeing%20737%20MAX%20March%202020.pdf.

clearly indicates that members of Congress are not immune from insider trading laws and owe a fiduciary duty of trust and confidence, it is difficult to determine what this duty specifically is and how it is defined. Second, the Speech or Debate Clause of the Constitution provides significant evidentiary hurtles investigators must overcome to successfully investigate and prosecute members of Congress for insider trading.

1. Ambiguity of the Fiduciary Duty Asserted in The STOCK Act

In the typical insider trading case, whether a defendant owes a fiduciary duty is easily identified. Individuals such as officers, directors, controlling shareholders, employees, and the corporation itself are fiduciaries as a matter of law and their obligations are clearly defined through well-established precedent making it easy for the court to apply the classical theory.[113] Under the misappropriation theory, defendants can be assumed to engage in a fiduciary-like relationship that requires them to keep confidence such as employer-employee, principal-agent, or client-attorney relationships.[114] Recall that the Supreme Court in *Chiarella* and *Dirks* indicated their intention to expand the category of relationships where a fiduciary-like duty arises when they used the phrase "fiduciary or other similar relation of trust and confidence."[115] However, Supreme Court has said little on how to identify which types of relationships fit this expanded category.[116]

Although the STOCK Act clearly indicates that members of Congress are not immune from insider trading laws and owe a duty of "trust and confidence," it is difficult to determine what this duty specifically is and how it is defined. Prior to the STOCK Act's passage, many commentors believed that members of Congress were immune from congressional insider trading.[117] A majority of commentors believed that this stemmed from the difficulty of establishing a breach of a fiduciary duty for members of Congress.[118] This majority view asserts that unlike employees of the other three branches of government who are agents and therefore subject to insider trading laws

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113 *See, e.g.*, *Chiarella*, 445 U.S. at 227–30 (summarizing established precedents of fiduciary relationships).

114 *Chestman*, 947 F.2d at 568.

115 *Chiarella*, 445 U.S. at 228; *Dirks*, 463 U.S. at 654.

116 Schroeder, *supra* note 53, at 187–88.

117 *See* Kim, *supra* note 19, at 847– 48 (stating that the majority view of commentators on Congressional insider trading assert that insider trading laws did not reach members of Congress); *see also* Stephen M. Bainbridge, *Insider Trading Inside the Beltway*, 36 J. CORP. L. 281, 295–96 (2011) (describing Congressional immunity to insider trading law as the "predominant view").

118 *See* Kim, *supra* note 19, at 848.

through their employer/employee relationships,[119] members of Congress are independent and are not employees of anyone.[120]

Recall that the language of the STOCK Act states that members of Congress owe a duty of trust or confidence to Congress, the United States Government, and the citizens of the United States.[121] Despite this language, it is difficult to see how a member of Congress violates this duty in a typical insider trading fact pattern. For example, say a member of Congress acquires inside information regarding an upcoming regulation that will greatly impact the profits of a particular company. The Congress member sells a significant amount of the company's stock, resulting in massive profits. They are certainly trading on nonpublic, material information in order to receive a competitive edge in the market. This satisfies the first three elements of an insider trading cause of action. But what fiduciary or fiduciary-like duty exists and how did they breach that duty? They did not breach a fiduciary duty under the classical theory because they are neither insiders nor constructive insiders within the meaning of the term. Under the misappropriation theory, it might be easier to argue that the congressional member broke their promise to keep nonpublic information confidential.[122] But what promise did the member of Congress break? Did they break their promise to the United States Government or to the citizens of the United States or to Congress itself?

Without a clearer picture of the duty owed by members of Congress when they acquire inside information, it might be difficult for prosecutors to bring an insider trading case.[123] The problem is coupled by the fact that ambiguity surrounds the phrase "trust and confidence" and the fact that many scholars prior to the STOCK Act believed that members of Congress were not fiduciaries to anyone.

2. The Speech or Debate Clause as the Major Evidentiary Hurdle

The second reason that the STOCK Act has been ineffective is due to the evidentiary hurtles associated with its implementation. These hurdles stem from the current interpretation of the Speech or Debate Clause of the

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119 *See* Bainbridge, *supra* note 117, at 297 (asserting that "no serious doctrinal obstacle precludes applying misappropriation theory [of insider trading] to *employees* of Congress, the Executive Branch, and other governmental agencies.") (emphasis added).

120 *See* Kim, *supra* note 19, at 849 (asserting that under this majority view, member of Congress are fiduciaries to no one because they are "neither employees nor agents of any larger entity.") (quoting *Insider Trading and Congressional Accountability: Hearing Before the S. Comm. on Homeland Sec. & Gov't Affairs*, 112th Cong. 4 (2011) (statement of John C. Coffee, Jr., Professor of Law, Columbia Univ.)).

121 STOCK ACT, Pub. L. No. 112–105 § 4(b)(2), 126 Stat. 291, 292 (2012).

122 LANGEVOORT, *supra* note 22, at § 6:1 (arguing that the misappropriation theory allows for government insiders to be prosecuted for insider trading).

123 Matthew Barbabella et. al., *Insider Trading in Congress: The Need for Regulation*, 9 J. BUS. & SEC. L. 199, 215 (2009).

Constitution.[124] The Speech or Debate Clause provides that: "Senators and Representatives shall . . . be privileged from Arrest during their Attendance at the Session of their respective Houses, and in going to and returning from the same; for any Speech or Debate in either House, they shall not be questioned in any other Place."[125] Generally, this Clause protects the right of members of Congress to conduct legislative activity without the threat of prosecution or interference by the Executive, but will not protect activity that does not have a legislative purpose.[126] The Supreme Court has applied this clause more broadly than merely protecting speeches and debates and has applied it to anything done in the legislative process, such as committee activity[127] and voting.[128] However, the Supreme Court has limited the immunity derived from the Clause by asserting that it does not protect against any conduct possibly related to legislation because this would lead members of Congress to assume that they are "above the law."[129]

Some scholars believe that the Speech or Debate Clause does not pose a significant hurtle to prosecution and investigation under the STOCK Act.[130] They argue that given the Supreme Court's treatment of other information-sharing acts as non-legislative acts, such as those that regulate press releases, the information implicated in insider trading should also not be privileged.[131] They argue that the conveyance of nonpublic information in the context of insider trading is not central to the legislative process and the actual trading of the information is even more removed from the legislative process, therefore making it available to investigators and prosecutors when looking into members of Congress for insider trading.[132]

This argument follows the reasoning put forth in *United States v. Brewster*, where the Supreme Court distinguished between taking a bribe which is a criminal, non-legislative act and the performance of the promise that the bribe required (in this case was to vote for a piece of legislation, an legislative act).[133] Using *Brewster*, one scholar argues that "[just as the Speech [or] Debate Clause does not prohibit members of Congress from being prosecuted

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124 Kane, *supra* note 48, at 111; Kim, *supra* note 19, at 915–19; Barbabella et. al., *supra* note 123, at 217–19.

125 U.S. CONST. art. I § 6, cl. 1.

126 Gravel v. United States, 408 U.S. 606, 616 (1972); *see* Barbabella et. al., *supra* note 123, at 218.

127 *See* Tenney v. Brandhove, 341 U.S. 367, 377–78 (1951).

128 *See* Kilbourn v. Thompson, 103 U.S. 168, 204 (1880).

129 *See* United States v. Brewster, 408 U.S. 501, 516 (1972) (preforming a legislative act as consideration for a bribe was not protected by the Speech and Debate Clause).

130 Fodor, *supra* note 86, at 632–33.

131 *See, e.g.,* Barbabella et. al., *supra* note 123, at 218–19 (citing cases where the Supreme Court has refused to grant immunity for information published by legislators in press releases).

132 *Id.*

133 *See Brewster*, 408 U.S. at 526; Fodor, *supra* note 86, at 632–33 (citing Bainbridge, *supra* note 117, at 303 (asserting that the Speech or Debate Clause does not present a significant hurtle by relying on the Supreme Court's holding in *Brewster*)).

for accepting bribes, it should not bar regulation of congressional insider trading."[134]

However, scholars who believe that the Speech or Debate Clause does not present a hurtle to combating insider trading under the STOCK Act fail to consider the D.C. Circuit's decision in *United States v. Rayburn House Office Building*.[135] In *Rayburn*, FBI agents, under a valid search warrant, entered the Rayburn Office Building and searched Representative William Jefferson's office in search of documents connected to an alleged fraud and bribery scheme.[136] The circuit court broadly interpreted the Speech or Debate Clause to hold that the search warrant was unconstitutional and that compelling disclosure of documents related to legislative acts violated the Clause.[137] Before the D.C. Circuit's decision in *Rayburn*, the Speech or Debate Clause was largely understood to allow members of Congress to refuse to testify about their involvement in legislative acts and did not include the privilege for an individual member of Congress to withhold documents that were sought under a valid warrant.[138] The Supreme Court denied to hear *Rayburn*,[139] and the individual guarantee that members of Congress are immune from disclosing any documents connected to legislative acts remains good law in the nation's capital.[140]

On the other hand, the Ninth Circuit in *United States v. Renzi* rejected former Representative Richard Renzi's argument that the Speech or Debate Clause included the privilege of nondisclosure for reports related to legislative actions.[141] However, the Supreme Court did not grant certiorari and the decision in *Rayburn* continues to be good law, while also creating a circuit split.[142]

As a result, the Speech or Debate Clause frustrates and might even bar a successful insider trading suit under the STOCK Act. Unlike in *United States v. Brewster*, where both the main evidentiary component and the underlying crime was the bribe, and the legislative act (voting on a piece of legislation) was merely ancillary to the bribe; in an insider trading case the evidentiary component is the conveyance of material, nonpublic information

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134 Bainbridge, *supra* note 117, at 303.

135 United States v. Rayburn House Office Bldg., 497 F.3d 654 (D.C. Cir. 2007), cert. denied, 552 U.S. 1295 (2008).

136 *Id.* at 656.

137 *Id.*; *see* Fodor, *supra* note 86, at 624 (the [D.C. Circuit] interpreted legislative privilege broadly to permit nondisclosure of covered materials to the Executive Branch or any of its agents, even in a criminal investigation) (citing *Rayburn*, 497 F.3d at 662–63).

138 *See* Fodor, *supra* note 86, at 610–11.

139 *Rayburn*, 552 U.S. at 1295.

140 *See* Brachman, *supra* note 8, at 292 (noting that the Rayburn decision is still good law in D.C. where most of the litigation of the Speech or Debate Clause takes place).

141 *See* United States v. Renzi, 651 F.3d 1012, 1037–39 (9th Cir. 2011), *cert. denied,* 565 U.S. 1157 (2012).

142 *See id.* at 1157; *see also* Klebon, *supra* note 12, at 174.

and the underlying crime is the trading and breach of fiduciary duty.[143] While the act of trading on insider information is not privileged; the material, nonpublic information – which is central to bringing a cause of action – will likely be perceived as legislative because it was likely acquired through the legislative process of Congress.[144] For example, during the DOJ's investigation into Senator Burr's trading activities, if federal authorities were to subpoena Senator Burr to answer questions regarding the material, nonpublic information he allegedly traded upon, the information would likely be privileged because it was acquired through senatorial briefings.[145] Similarly, if investigators were to issue a warrant for Senator Burr's cell phone the decision in *Rayburn* would be implicated because the Senator most likely used his cell phone to conduct congressional business.[146]

Insider trading is already extremely difficult to prove, and prosecutors require specific information surrounding the transfer of insider information to bring a case. If members of Congress are able to invoke the nondisclosure privilege endorsed in *Rayburn*, then the STOCK Act looks more like a political stunt rather than a real deterrent to congressional insider trading. As one scholar puts it: "[t]he post-*Rayburn* environment created an arbitrage opportunity" where "the Act's passage without [a] wavier [of legislative privilege] will game the system."[147]

III. CONGRESS OWES A FIDUCIARY DUTY TO CONGRESS AS AN INSTITUTION

As previously discussed, the uncertainty surrounding the duty that a member of Congress owes (and breaches) when they engage in insider trading frustrates the ability of the STOCK Act to be enforced. One possible solution to the problem is to rely on analogical reasoning to assert that members of Congress are fiduciaries to Congress by virtue of how they receive nonpublic information. In the next section I will discuss how this understanding of the fiduciary relationship could potentially alleviate the evidentiary burdens associated with the Speech or Debate Clause by providing evidence that a waiver of the protection should be granted for the purposes of investigating insider trading allegations.

Recall that the SEC promulgated Rule 10b5-2, intended to clarify when a relationship of "trust and confidence" arises under the misappropriation

143 Fodor, *supra* note 86, at 633 (citing *Brewster*, 408 U.S. at 526).

144 *See* Brachman, *supra* note 8, at 294–95.

145 Robert Anello, *How Senators May Have Avoided Insider Trading Charges*, FORBES (May 26, 2020, 9:28 PM), https://www.forbes.com/sites/insider/2020/05/26/how-senators-may-have-avoided-insider-trading-charges/?sh=247afc5b27ba.

146 *Id.*

147 Fodor, *supra* note 86, at 634.

theory.[148] Specifically, the rule states that a duty of trust or confidence exists when parties sharing material nonpublic information have a "history, pattern, or practice of sharing confidences" such that the person receiving the information knows that they are expected to keep the information confidential.[149] In the context of congressional insider trading, the question becomes whether a relationship between Congress as a whole and its individual members have a "history, pattern, or practice of sharing confidences" suggesting that Congress expects its members to keep certain information confidential.

Evidence of a relationship where members are expected to keep information derived from their positions in Congress confidential can be found in the Code of Ethics for Government Services.[150] The Code of Ethics states that any person engaged in government service should "[n]ever use any information coming to him confidentially in the performance of governmental duties as a means for making private profit." This regulation mimics the well-established common law ban on fiduciaries using information derived from their position to pursue secret private profits.[151] What is unique about this regulation is that it pulls from common law fiduciary law and applies it equally (to all members of the United States government) including members of Congress who are not de-facto fiduciaries by virtue of their employer/employee relationship.[152] If presented to a court, this regulation could provide the necessary evidence to assume that members of Congress have assumed a fiduciary-like duty of trust and confidence to Congress by virtue of adhering to this regulation.

Furthermore, as a practical matter, it makes sense that members of Congress are in a fiduciary-like duty of trust and confidence with Congress as a whole. As Professor Sung Hui Kim points out, the relationship between a member of Congress and its individual members can be analogized to the relationship between individual partners and the partnership itself.[153] Under the Revised Uniformed Partnership Act ("RUPA"), the "fiduciary duties a partner owes to the partnership and the other partners are the duty of loyalty and the duty of care."[154] Under partnership law, each member of a partnership is both an agent and principle and owes a fiduciary duty of loyalty to every

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148 *See* Section I(C)(1) for a complete overview of Rule 10b5-2(b)(2).

149 17 C.F.R. § 240.10b5-2(b)(2) (2020). Note that SEC v. Cuban called into question the validity of Rule 10b5-2, 634 F. Supp. 2d 713, 714 (N.D. Tex. 2009) but the case was vacated and remanded by the Fifth Circuit who did not reach a decision on the validity of 10b5-2. *See* SEC v. Cuban, 620 F.3d 551 (5th Cir. 2009).

150 Code of Ethics for Government Service, 21 C.F.R. § 19.6 (1958).

151 It is well-established law that a fiduciary has a duty of loyalty to their principle that forbids them from using their position to profit individually. *See* AM. JUR. 2D CORPORATIONS § 1467 (2022).

152 Recall that unlike other positions in government, legislators are not in an employee/employer relationship. *See* section II(C)(1).

153 *See* Kim, *supra* note 19, at 885–87.

154 Revised Uniform Partnership Act § 404(a) (2006)) [hereinafter RUPA]; *see also* § 12:15, Partnership fiduciary duties under RUPA: In general, Partnership Law & Practice § 12:15 (2022–2023).

other partner in the partnership and the partnership as a whole.[155] Furthermore, RUPA defines a partnership as a "association of two or more person to carry on as co-owners of a business for profit . . . whether or not the persons intend to form a partnership."[156]

In using this analogy, Sung Hui Kim notes that members of Congress do not join together to carry on a business for profits, but they do come together to carry on a singular enterprise: the business of Congress.[157] Members of Congress forsake other possible business ventures and come together to pass legislation and the success of their venture depends on working together with fellow lawmakers.[158] Similar to how partners share in the control of a partnership equally, individual members of Congress have equal standing in Congress and their ability to enact change is dependent on the whole of Congress.[159]

Furthermore, when a member of Congress acquires inside information, they do so through their participation in Congress. Through hearings, committee reports, and floor deliberation, members of Congress acquire confidential information that is intended to be used to draft effective legislation in Congress. Under the misappropriation theory, a partner in a partnership violates their fiduciary duty of loyalty when they use information acquired through the partnership to trade.[160] Similarly, members of Congress violate their duty of trust and confidence to Congress when they trade on information acquired through Congress.

Overall, this analogy provides further evidence that under Rule 10b5-2 a "history, pattern, or practice of sharing confidences" exists for members of Congress. Combining this with the fact that the Code of Ethics for Government services forbids government actors from using confidential information for profit, a court should have little trouble applying the misappropriation theory to a member of Congress for insider trading under the STOCK Act. This framework clarifies the duties under the STOCK Act by providing a straightforward framework for federal investigators and courts to use the STOCK Act as an effective enforcement mechanism.

IV. HOW THIS DEFINITION STRENGTHENS THE STOCK ACT

Using the framework above gives clarity to the STOCK Act by providing a clear path for asserting an insider trading claim against a member of Congress. However, it does not (yet) directly solve the evidentiary issues

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155 *See* Kim, *supra* note 19, at 885 (citing RUPA § 404(a) (2006)).

156 RUPA § 202(a).

157 *See* Kim, *supra* note 19, at 886.

158 *Id.*

159 *Id.*

160 SEC v. Peters, 735 F. Supp. 1505, 1521 (D. Kan. 1990) (finding that a partner potentially violated his fiduciary duty to his partner under the misappropriation theory when he traded on confidential information).

implicated by the Speech or Debate Clause. As previously discussed, without the ability for investigators to issue subpoenas and search warrants to demonstrate that a member of Congress used material, nonpublic information to trade, an indictment under the STOCK Act is unlikely. The purpose of this section is to provide an argument that classifying the relationship between Congress as a whole and its members as a fiduciary-like relationship of trust and confidence advances an argument for a waiver of the protections under the Speech or Debate Clause for the purposes of investigating insider trading.

In *United States v. Helstoski*, the Supreme Court held that a federal statute that outlawed bribery did not create a waiver of legislative privilege under the Speech or Debate Clause.[161] However, the Court left open the possibility of Congress instituting a waiver if certain conditions are met. The Court concluded that a waiver would be constitutional only if "an explicit and unequivocal expression" was expressed by Congress.[162] In *Helstoski*, this burden was not met in the case of the bribery statute.[163] In *United States v. Brewster*, Justice White dissented from the majority opinion insisting that the Speech or Debate Clause did not foreclose the ability of Congress to regulate its own members: "[t]he Speech or Debate Clause does not immunize corrupt Congressman. It reserves the power to discipline in the Houses of Congress."[164] As Justice White notes, Congress can and should police its own members for actions that violate their ethics as well as the laws of the United States.

The STOCK Act indicates that members of Congress are not immune from insider trading laws. As I argued above, each member of Congress owes a fiduciary duty of trust and confidence to their fellow Congressmen and Congress as a whole, similar to how a partner owes a fiduciary duty to their fellow partners and the partnership as a whole. Under partnership law, partners may govern their internal affairs through the agreement of a majority of partners.[165] Any action taken to regulate the internal affairs of the partnership is binding if taken in good faith and within the scope of the partnership's business.[166]

Similarly, Congress has the power to self-regulate and police its members in a way they see fit. An internal mechanism that keeps Congress out of the press and prevents allegations that undermine the confidence of Congress can be said to be part of Congress's "internal affairs." Furthermore, Congress already has statutes and regulations in place that do regulate its internal affairs. For example, Congress has already enacted specific statutes aimed at combating bribes and eliminating conflicts of interests for all government

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161 Fodor, *supra* note 86, at 635 (citing United States v. Helstoski, 442 U.S. 477, 493 (1979)).

162 *Helstoski*, 442 U.S. at 493.

163 *Id.*

164 Brewster, 408 U.S. at 563 (White, J., dissenting).

165 AM. JUR. 2D PARTNERSHIP § 273 (2022).

166 *Id.*

officials, including members of Congress.[167] Moreover, Congress has already instituted some internal mechanisms to oversee and investigate the conduct of congressional members. A good example of these internal mechanisms is the Office of Congressional Ethics ("OCE").[168] First authorized by the House of Representatives in 2008, the OCE is an independent investigatory panel whose powers include the ability to investigate and punish members of both parties in the House of Representatives.[169] The panel is composed of six members, three being nominated from each political party, and is answerable to the whole of the House by a majority vote.[170] The powers of the panel extends to investigating any member of the House of Representatives or employee of a member for "any law, rule, regulation, or other standard of conduct."[171] Additionally, the panel has the power to hold hearings, solicit testimony, and attain relevant evidence.[172] Upon completing their investigation, the OCE drafts a written report where they lay out all material facts and evidence produced during an investigation and recommends whether any subpoenas should be issue to further investigate the matter.[173] Although the Senate does not have a similar panel, they could easily authorize one to investigate broadly, like the OCE, or to limit its scope to allegations of insider trading.

Additionally, because the investigations under the STOCK Act would be internal, considerations surrounding Executive encroachment would not be implicated. This means that the evidentiary hurtles implicated in the Speech or Debate Clause would likely not pose a problem for these panels. In turn, these panels could vet viable claims of insider trading and then refer the manner to federal investigators from the DOJ and SEC. Of course, federal investigators might still run up against the legislative privilege problems associated with the Speech or Debate Clause. But, this filtering function, where allegations of insider trading are first investigated internally and then passed to the Executive upon the recommendation of the internal panel for further investigation, supports an argument that Congress should create a waiver of the protections under the Speech or Debate Clause for the STOCK Act. Once an internal panel finds creditable evidence that a member of Congress improperly used material, nonpublic information to trade on the stock market, then it makes sense that federal investigators should be able to proceed freely to create a case against that member of Congress. Additionally, if Congress

167 *See, e.g.*, 18 U.S.C. § 201(b)(1)(a) (1994) (stating that it is a crime for a public official to engage in conveyance of anything of value with the intent to influence any government activity); 18 U.S.C. § 201(c) (1994) (it is a crime for a government official to accept any gratuity for their performance of an official act). Note that members of Congress are included in the covered positions under this act. 18 U.S.C. § 201(a)(1); *see, e.g.*, Ethics in Government Act of 1978, Pub. L. No. 95-521, 92 Stat. 1824 (codified as an amendment in scattered sections of 2, 5, 18 and 28 U.S.).

168 H.R. Res. 895, 110th Cong. (2008).

169 *See* H.R. Res. 895, § (I).

170 *Id.* at § (I)(b).

171 *Id.* at § (I)(c).

172 *Id.* at § (I)(c)(ii)(2)(D).

173 *Id.* at § I(c)(ii)(2)(C)(i–ii).

would institute an explicit and specific waiver of the protections under the Speech or Debate Clause using this framework, it would probably receive Supreme Court endorsement. Especially if the waiver is conditioned upon a recommendation from an internal panel.

CONCLUSION

The story of a legislator using their lofty position on Capitol Hill to trade on insider information for their own financial benefit creates strong sentiments of injustice. It reeks of unfairness and pulls on the heartstrings of all Americans regardless of their political predisposition. We were told that the STOCK Act was passed to put an end to congressional insider trading. However, the ambiguity surrounding the fiduciary duty owed by members of Congress was not solved by the STOCK Act, and the evidentiary hurtles posed by the Speech or Debate Clause were not eliminated by the Act's passage. Instead, Congress continues with business as usual, acquiring inside information and profiting on the market.

As discussed above, the fiduciary relationship between partners in a partnership mimics the relationship that legislators have with their fellow members of Congress and Congress as a whole. Federal prosecutors and courts should use this framework to assert that members of Congress breach their fiduciary duty to Congress when they engage in insider trading. Furthermore, Congress is compelled to internally investigate its own members for violations of its ethics and the laws of the United States. Doing so, however, requires Congress to forsake some of the privileges they enjoy under the Speech or Debate Clause through a waiver. The best way to do this is to compromise and create an internal vetting protection before members of Congress are open to investigation by federal authorities. This framework provides a compromise between the necessary protections against Executive encroachment within the Speech or Debate Clause and the necessity for federal authorities to be able to prosecute the criminal activities of Congress. Given the warranted public perception that members of Congress are in fact above the law when it comes to insider trading, and the lack of progress Congress has made in combating this perception, it makes sense that this compromise is warranted for the STOCK Act.

KHAN'S ANTITRUST PARADOX

Cory Jack

INTRODUCTION

Antitrust law, at its core, is a common law field. Significant legislation has been enacted and developed globally, but in the United States, the federal legislation is extraordinarily vague. Perhaps unsurprisingly, the common law accompanied by economic science has filled the gap where the statutory grants were unclear.

After a period of structuralism in the 1960s and 1970s, the Chicago School of Thought took hold and is now accepted in the antitrust jurisprudence. However, the Biden administration, led by Federal Trade Commission Chair Lina Khan and Department of Justice Antitrust Division Assistant Attorney General Jonathan Kanter, think the Chicago School has failed in critical aspects, particularly in Big Tech and that a return to structuralism is necessary. While courts have not yet accepted the propositions set forward by the Biden administration, the administration continues to push forward. In this comment, I argue that where the Consumer Welfare Standard fails, the Total Welfare Standard does not. Further, I argue that where the structuralist approach advocated for by the Biden administration fails, the Total Welfare Standard does not. Therefore, the Biden administration and the antitrust community should consider a Total Welfare regime for antitrust law and policy.

In Section I, I provide a detailed background on the evolution of antitrust law in the U.S. leading up to and through the passage of the Sherman Act. I continue to outline how the Consumer Welfare Standard became dominant and what the Biden administration is advocating for. I look at the economic learnings that have developed in line with antitrust law and policy. Specifically, I focus on why price effects are the relevant metric and how non-price metrics can, and are, accounted for in price effects and the merits of structuralism.

In Section II, I introduce the Total Welfare Standard and then compare it to the Consumer Welfare Standard and the structural approach. In Section III, I apply the Total Welfare Standard to the issues commonly raised about Big Tech and conclude that the Total Welfare Standard can adequately address the issues better than the Consumer Welfare Standard or a structural approach. Finally, in Section IV, I address the common counterarguments that have been presented or are likely to be presented against a Total Welfare Standard. Specifically, I address administrative costs and the supposed statutory purpose of the antitrust laws.

I. THE CHICAGOAN AND NEO-BRANDEISIAN REVOLUTIONS

In the later 1800s, firms began to organize themselves in what are today known as trusts. These trusts aggregated power in industries and resulted in significant control of markets by few market participants. The Sherman Act was passed in 1890 as a response to concerns about this concentration of economic power, which was perceived as a threat to competition and innovation.[1] The Sherman Act prohibited certain types of anticompetitive conduct, such as price fixing and monopolization, and empowered the federal government to take legal action against companies that violate its provisions. The purpose of the Sherman Act was to promote competition and protect consumers from anticompetitive practices that could lead to higher prices, and reduced choice and quality in the marketplace.

But the Sherman Act failed to sufficiently curb anticompetitive behavior. The Clayton Act was passed in 1914,[2] just three years after the Standard Oil decision by the Supreme Court. In 1911, the government sued Standard Oil for a handful of monopolizing practices under Section 2 of the Sherman Act.[3] Standard Oil decreased prices when competition or the threat of competition was present and subsidized below-cost prices in competitive market with excess profits in less competitive markets.[4] The Court found such practices in violation of the Sherman Act and ordered the break-up of the trust.[5]

The Clayton Act bolstered the Sherman Act's weaknesses. Specifically, the Act included sections to limit predatory pricing, price discrimination, and potentially anticompetitive mergers and acquisitions.[6] Such interest in limiting price discrimination was further emphasized in the Robinson-Patman Act in 1936,[7] however, the Robinson-Patman Act has not seen the same level of enforcement as the Sherman and Clayton Acts to date.[8]

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[1] 15 U.S.C. §§ 1—7 (2012).

[2] *Id.* §§ 12—27 (2012); 29 U.S.C. § 52—53 (2012).

[3] Standard Oil Co. of N.J. v. United States, 221 U.S. 1 (1911).

[4] *See* IDA M. TARBELL, A HISTORY OF THE STANDARD OIL COMPANY 6–7 (1904).

[5] *Standard Oil*, 221 U.S. at 81–82.

[6] *See* Lina M. Khan, *Amazon's Antitrust Paradox*, 126 YALE L. J. 710, 723 (2017) (noting "The House Report stated that Section 2 of the Clayton Act was expressly designed to prohibit large corporations from slashing prices below the cost of production "with the intent to destroy and make unprofitable the business of their competitors" and with the aim of "acquiring a monopoly in the particular locality or section in which the discriminating price is made."); *see also* Herbert Hovenkamp, *United States Competition Policy in Crisis: 1890-1955*, 94 MINN. L. REV. 311, 363 (2009).

[7] 15 U.S.C. §§ 13–13b, 21a (2012).

[8] Although this may be changing soon. Newly appointed FTC Commissioner Bedoya has emphasized interest in bringing agency action under the RPA. *See* Leah Nylen, *FTC's Bedoya Presses for Return to Fairness Over Efficiency*, BLOOMBERG L. (Sept. 22, 2022), https://news.bloomberglaw.com/antitrust/ftcs-bedoya-presses-for-return-to-fairness-over-efficiency.

But whether banning price discrimination is beneficial or not is well-debated.[9] From the perspective of the consumer, bans on price discrimination by producers is almost always beneficial for consumers. Most consumers will be guaranteed consumer welfare, in this sense, defined as the difference between the consumers' willingness to pay and the price they actually pay. For example, say two fliers demand a flight from Washington to California. One is willing to pay $500 for the ticket and the other is only willing to pay $300. If the airline is not able to charge based on their willingness to pay, they will charge one flat rate, say $300, meaning that at least one of the consumers will capture some consumer surplus. Producers aren't necessarily harmed by such a ban, as producer welfare does not decrease, here producer welfare is defined as the difference between the producers' willingness to sell and the price they actually sell at.

The debate gets interesting in the context of the Consumer Welfare Standard. The Consumer Welfare Standard seeks to protect consumer welfare. Therefore, it seems intuitive under the Consumer Welfare Standard that price discrimination should be banned. But price discrimination doesn't decrease welfare overall. It merely shifts the welfare captured between producers and consumers. If price discrimination is legal–and assuming the producers can predict or know what consumers' willingness to pay is–producers are able to decrease the margin between the consumers' willingness to pay and price actually paid. In other words, the amount consumer welfare decreases by is the same amount producer welfare increases by–a shift in welfare from consumers to producers.

Whether or not such a shift is harmful in itself is subject to extensive debate.[10] But there is much more to the price discrimination story. There are often scenarios where price discrimination is necessary for a firm to profitably survive.[11] Further, there are scenarios where price discrimination results in both an increase in producer welfare *and* consumer welfare.[12]

Over time, antitrust doctrine has changed significantly. In the 1960s through the late 1970s, the Harvard School of thought prevailed. The Harvard School emphasized a structuralist approach, a presumptive analysis interested in the number of firms in a market and their relative sizes.[13] Such an approach presumed that as a firm controls more of a market, the firm can act

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9 *See* James Cooper et al., *Does Price Discrimination Intensify Competition? Implications for Antitrust*, 72 ANTITRUST L.J. 327 (2005); William J. Baumöl & Daniel G. Swanson, *The New Economy and Ubiquitous Competitive Price Discrimination: Identifying Defensible Criteria of Market Power*, 70 ANTITRUST L.J. 661 (2003).

10 *See generally* Juan M. Elegido, *The Ethics of Price Discrimination*, 21 BUS. ETHICS Q. 634 (2011).

11 *Id.* at 638; Baumöl & Swanson, *supra* note 9.

12 Elegido, *supra* note 10, at 639–40.

13 *See* Thomas A. Piraino, Jr., *Reconciling the Harvard and Chicago Schools: A New Antitrust Approach for the 21st Century*, 82 IND. L.J. 345, 348–49 (2007).

more anticompetitively.[14] Such a proposition was supported by early antitrust cases like *Standard Oil Co. v. United States*, where Standard Oil both controlled a more than significant share of the rail industry and also acted anticompetitively.[15]

While certainly in some scenarios such a presumption would correctly prevent anticompetitive conduct, for most situations such a presumption was unwarranted.[16] For example, in *United States v. Aluminum Co. of Am.*, the Second Circuit concluded that the Aluminum Company of America's concentration of market share was in violation of Section 2 of the Sherman Act despite the extensive cost savings consumers would experience through efficiencies gained from such increased market concentration.[17]

Structural presumptions have perhaps left their strongest market in *United States v. Philadelphia National Bank*. In *Philadelphia National Bank*, the 1963 court established a Clayton Section 7 presumption that if a proposed merger would result in a market share in excess of thirty percent, the merger was presumptively unlawful.[18] Such a presumption has been widely regarded as harmful to a healthy economy and doesn't comport with current economic understandings.[19] Despite all this, *Philadelphia National Bank* has not been overturned and is still good law, although the *PNB* presumption has been invoked significantly less over the years.[20]

Such a tradeoff would be resolved (to some extent) by the change in antitrust law towards the Consumer Welfare Standard advocated for by the Chicago School.

A. *The Chicago School's Consumer Welfare Standard*

Over the years, perhaps spurred by antitrust's presumptive enforcement, economic research and antitrust law and policy changed towards an effects-based approach. The Chicago school, pioneered by legends like Robert Bork, Frank Easterbrook, and Richard Posner, changed antitrust towards a more comprehensive framework. Instead of presuming that certain practices were

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[14] One of the most common critiques to the structural presumption approach is that they mistake causation for correlation. While there may be some relationship between a firm's market share and its anticompetitive behavior, the story is certainly more complex. For example, assuming that just because a firm controls greater ninety percent of a market doesn't mean it obtained that market share through anticompetitive means. It could be the case that that firm has a significantly superior product to its competition and thus captured the market share through competition.

[15] *See generally Standard Oil*, 221 U.S. 1.

[16] *See* United States v. Aluminum Co. of Am., 148 F.2d 416 (2d Cir. 1945).

[17] *Id.*

[18] United States v. Phila. Nat'l Bank, 374 U.S. 321 (1963).

[19] *See* Douglas H. Ginsburg & Joshua D. Wright, *Philadelphia National Bank*: *Bad Economics, Bad Law, Good Riddance*, 80 ANTITRUST L.J. 377 (2015).

[20] *See generally Phila*. *Nat'l Bank*, 374 U.S. 321.

anticompetitive and therefore illegal, the school emphasized actual evidence tying the practice to anticompetitiveness. For example, many of the per se illegal practices covered under Section 1 of the Sherman Act like price fixing and market allocation were in one case or another shifted towards a more comprehensive rule of reason analysis.

Price fixing, for instance, which was traditionally considered to be anticompetitive in almost any instance, was subjected to a full rule of reason analysis in *Broadcast Music, Inc. v. CBS, Inc.*[21] In the 1979 case, Broadcast Music sold blanket licenses to CBS for set prices of many aggregated individual musical compositions, and CBS argued that such practice was per se illegal price fixing.[22] The Court held that the practice was not per se illegal because the alternative to the practice was not feasible.[23] Individual music composers could not reasonably license out their music to each person interested in listening to it.[24] Broadcast Music reduced the transactions costs of buying and selling music compositions for millions of producers (think musical artists) and consumers (think music listeners) such that a market could not exist but for such "price fixing."[25]

The shift away from presumptions of illegality also signaled a larger change in antitrust law. The burden-shifting regime began to dominate the jurisprudence. The government (or third-party Plaintiff) had to surpass an initial burden that a practice was anticompetitive. If that burden was met, then the burden shifted to the Defendants to show either that the practice was not anticompetitive (disproving the Plaintiffs evidence) or show that efficiencies derived from the merger would outweigh any anticompetitive harm.[26]

As the field of economics continued to develop, more and more evidence indicated that the market share and concentration in an industry was not a guarantee of anticompetitive behavior. In fact, significant market shares often signaled that a firm was the best in that industry. So long as a firm legitimately competed to obtain such significant market shares, they ought be rewarded with the supracompetitive profits derived through their legitimate acquisition of that power.

The supracompetitive profits are a driving factor of innovation, competition, and entry into markets. Firms have a strong incentive to enter markets where more than normal profits are being made. Such entry, invariably results in increased competition, resulting in a regression to the mean where such supracompetitive profits vanish over time.

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21 441 U.S. 1 (1979).

22 *Id.* at 6.

23 *Id.* at 7, 24.

24 *Id.* at 20.

25 *Id.* at 20–21.

26 Such burden-shifting regime is still in play today. Depending on what a case is brought under, there may be an additional third burden on the Plaintiffs to show that the procompetitive justifications purported by the Defendants were the least burdensome way of achieving such efficiencies. *See* NCAA v. Alston, 594 U.S. 69, 106 (2021).

The Consumer Welfare Standard as advocated for by the Chicago School has essentially controlled antitrust law and policy since the early 1980s up until recently. While there have been continued debates amongst the Harvard and Chicago School, the economic evidence supporting the Chicago School has lent it the most support.[27] Further, the Chicago approach almost always results in more in-depth analysis considered by the courts–Decreasing the likelihood of Type I and II errors.

B. *"Hipster" Antitrust*

Up until the Biden administration, antitrust law and policy has accepted the principles established by the Chicago School. The economic foundations have proven useful and accurate in antitrust and merger analysis. Merger retrospectives indicated that antitrust enforcement was not significantly under- nor over-deterring competitive conduct.[28] However, the Biden administration, and its principal antitrust actors, see things differently.[29] Lina Khan, Chair of the FTC and Jonathon Kanter, Assistant Attorney General for the Antitrust Division of the DOJ, have extensive literature criticizing the approach adopted in current antitrust jurisprudence, especially in the context of Big Tech.[30]

Chair Khan wrote the somewhat legendary Yale Law Journal Note "Amazon's Antitrust Paradox" outlining how Amazon strategically escaped antitrust enforcement through different weak spots in the current antitrust regime.[31] For example, Amazon escaped predatory pricing enforcement under the current antitrust regime.[32] Under the current jurisprudence, a predatory pricing case is established when (1) a firm charges for each unit of output below the cost of production of that unit; and (2) there is dangerous likelihood

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27 For a complete defense of the Consumer Welfare Standard, see The *Consumer Welfare Standard* in *Antitrust*: Outdated or a *Harbor* in a *Sea of Doubt?: Hearing Before the Subcomm. on Antitrust, Competition and Consumer Rights* of *the Subcomm. on the Judiciary*, 115th Cong. (2017) (statement of Honorable Joshua Wright, Exec. Dir. of the Glob. Antitrust Inst., George Mason Univ. Antonin Scalia Law School).

28 *See* Orley Ashenfelter et al., *Retrospective Analysis of Hospital Mergers*, 18 INT'L J. ECON. BUS. 5 (2011).

29 For an attack on "Hipster Antitrust," see Joshua D. Wright et al., *Requiem for a Paradox: The Dubious Rise and Inevitable Fall of Hipster Antitrust*, 51 ARIZ. ST. L.J. 293 (2018).

30 While there is no one definition of Big Tech, Big Tech almost always includes the following firms: Alphabet (Google), Amazon, Apple, Meta (Facebook), and sometimes Microsoft. These firms dominate their respective industries, often experience network effects, and are often accused of being anticompetitive in one way or another.

31 Khan, *supra* note 6, at 755–56.

32 *Id.* at 753 ("The fact that Amazon has been willing to forego profits for growth undercuts a central premise of contemporary predatory pricing doctrine, which assumes that predation is irrational precisely because firms prioritize profits over growth.226 In this way, Amazon's strategy has enabled it to use predatory pricing tactics without triggering the scrutiny of predatory pricing laws.").

that the firm would be able to recoup those losses in the future at supracompetitive levels.[33]

The Chicago School, notably Bork, argued that pricing below cost is irrational and rarely occurs.[34] Further, such below cost pricing comes with no guarantee that their competition would actually be induced to leave the market nor re-enter after the predator raises prices to recoup their losses. Such guaranteed upfront losses with only potential recapture prevents most firms from pricing predatorily.

As Chair Khan highlighted in her note, Amazon consistently priced predatorily and yet evaded prosecution through practices that did not clearly violate the test as set out in *Brooke Group*. For instance, Amazon changes prices more than 2.5 million times each day which makes determining whether they are charging below cost for a specific product difficult.[35] Further, it is possible that Amazon cross-subsidized between products. For example, Amazon may have "loss-led" to get purchasers to buy that product *and* others that were not sold at below cost.

Regardless, the Neo-Brandeisians advocate for a return to a more structuralist approach. In Chair Khan's case, she advocated for structural presumptions for predatory pricing over the current test as established by *Brooke Group*.[36]

Other reasons for such a return to structure have been presented in the context of Big Tech as well. Specifically, structural presumptions when network effects and control over data are present which (supposedly) allow for more anticompetitive conduct.[37]

But moving from the nearly four decades of consumer welfare standard supported by the Chicago School to the structural approach seen in the 1960s is no easy leap. Many of the problems outlined by the Neo-Brandeisians have more than one solution. In the following sections I will address the Total Welfare Standard as a feasible alternative to both the Consumer Welfare Standard and the Structuralist approach advocated for by the Biden administration.

II. THE TOTAL WELFARE STANDARD COMPARED TO THE CONSUMER WELFARE STANDARD AND THE STRUCTURAL APPROACH

Whether a shift away from the Consumer Welfare Standard is warranted is a question in itself. Clearly the Biden administration sees problems with the current antitrust jurisprudence and is thus changing the field. But moving

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33 *See* Brooke Grp. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 223–25 (1993).

34 *See* Khan, *supra* note 6, at 727 n.82.

35 *See id.* at 763 n.271.

36 *See generally id.* at 729.

37 *See generally* David S. Evans, *The Antitrust Economics of Multi-Sided Platform Markets*, 20 YALE J. ON REG. 325 (2003).

away from the Consumer Welfare Standard has not been seen in decades. Below I outline the Total Welfare Standard, the Consumer Welfare Standard and the Structural approach that is where the Biden administration seems to be shifting antitrust law and policy.

A. *The Total Welfare Standard*

The Total Welfare Standard is a close cousin of the Consumer Welfare Standard. In fact, somewhat confusingly, in Judge Bork's Antitrust Paradox, Bork referred to the Total Welfare Standard as the Consumer Welfare Standard.[38] But there are important distinctions between the two welfare standards. Hopefully obvious from their names, one emphasizes aggregate welfare overall whereas the other focuses on just consumers.[39]

The Total Welfare Standard's principal goal is to maximize total welfare. This means that the distribution of welfare between consumers and producers is not necessarily relevant under such a regime. For instance, under the Total Welfare Standard, the goal is to have the largest pie. The size of the slice of the pie that goes to the consumers does not necessarily matter. Similarly, the size of the slice of the pie that goes to the producers also does not matter. This differs from the Consumer Welfare Standard where the goal is not to have the biggest pie, but to have the biggest slice of the pie for consumers.[40]

There is extensive debate over which regime is better and there are certainly costs and benefits of each. For example, under the Total Welfare Standard, on aggregate, the world is a better place–there is more pie. But just because there is more pie does not mean consumers are getting any. It is possible that producers have figured out how to perfectly price discriminate such that the consumers get an infinitesimally small slice of pie, and the producers get almost the entire pie. This is contrasted by the Consumer Welfare Standard where consumers are guaranteed their substantial slice of the pie at the cost of maximizing total welfare amongst consumers and producers.

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38 *See* Kenneth Heyer, *Consumer Welfare and the Legacy of Robert Bork*, 57 J.L. & ECON. S19 (2014).

39 Total welfare is defined as the aggregate of consumer welfare and producer welfare. *See* Christine S. Wilson, Comm'r, U.S. Fed. Trade Comm'n, *Welfare Standards Underlying Antitrust Enforcement: What You Measure is What You Get*, Luncheon Keynote Address at the George Mason Law Review 22nd Annual Antitrust Symposium: Antitrust at the Crossroads? (Feb. 15, 2019), https://www.ftc.gov/system/files/documents/ public_statements/1455663/welfare_standard_speech_-_cmr-wilson.pdf.

40 *See id.*

B. *The Total Welfare Standard compared to the Consumer Welfare Standard*

Under the Consumer Welfare Regime there are two conventional burden shifts in the regime. The first burden is placed on the Plaintiff to prove that the Defendant has acted anticompetitively. If the Plaintiff successfully shifts their burden, the Defendants then must either disprove the evidence the Plaintiffs provided supporting their anticompetitive conclusion or show that the efficiencies derived from the action outweighs any anticompetitive effects.

Unfortunately, this "efficiencies defense" has not fared well in the antitrust jurisprudence. Under the Consumer Welfare regime, efficiencies defenses are known to be losing cases.[41] In fact, an article examined twenty-five years of Section 7 Clayton Act cases in which efficiency defenses were raised and found that courts are not actually completing the rigorous comparison between procompetitive justifications (efficiencies) and anticompetitive harms.[42]

Some proponents of the Total Welfare Standard argue that the policy aspirations of the Consumer Welfare Standard can be better served by the Total Welfare Standard. For instance, such redistributional efforts can be achieved through other means after the pie has been maximized by the Total Welfare Standard rather than the smaller size seen under the Consumer Welfare Standard.[43]

C. *The Total Welfare Standard compared to the Structural Approach*

The Neo-Brandeisian Approach advocates for a return to the 1960s Structuralist rules that allow simple and quick enforcement by the agencies and courts without regard to economic evidence. But ultimately, it appears that the Neo-Brandeisian Approach is "fixing" the antitrust problems seen in Big Tech that the Consumer Welfare Standard could not address. "In order to capture . . . anticompetitive concerns, we should replace the [C]onsumer [W]elfare [Standard] with an approach oriented around preserving a competitive process and market structure."[44] For example, Amazon's seeming

[41] *See* New York v. Deutsche Telekom AG, 439 F. Supp. 3d 179 (S.D.N.Y. 2020) (This is the primary case that won on an efficiencies defense).

[42] *See* Jamie Moffitt, *Merging in the Shadow of the Law: The Case for Consistent Judicial Efficiency Analysis*, 63 VAND. L. REV. 1695, 1698 (2010) ("Although courts claim to be balancing merger generated efficiencies with other negative factors affecting market competition, they are not in fact doing so.").

[43] *See* Kenneth Heyer, *Welfare Standards and Merger Analysis: Why Not the Best?*, 2 COMPETITION POL'Y INT'L 28 (2006).

[44] *See* Khan, *supra* note 6, at 803.

evasion of predatory pricing cases was one of the central messages of Chair Khan's note.

Antitrust concerns often arise when barriers to entry are significant. This is extremely prevalent in Big Tech markets. For example, Meta, formerly Facebook, has purportedly invested over $36 billion dollars into building the metaverse.[45] If such an investment pays off and Meta controls the premier metaverse or virtual reality platform, it will be extraordinarily difficult for competition. Very few firms have access to the many-billion-dollar investment Meta has made and thus success may result in monopolistic power in the market.

While the Neo-Brandeisians seek to prevent such acquisition of market power in the first place, as evidenced by the FTC challenge of the Meta acquisition of Within,[46] under a Total Welfare Standard approach, such conduct would be evaluated by comparing all the costs and all the benefits of Meta's action. The case is somewhat similar to *Verizon v. Trinko*, where the Supreme Court held that Verizon had no duty to share their infrastructure with their competition.[47]

In *Trinko,* Verizon was a major competitor in the telephone and internet service industries. Verizon had an extensive network of telephone lines that allowed them to provide service across the nation. However, Verizon refused to deal with competitors and contract with them so they could use Verizon's network.[48] The Supreme Court held that Verizon committed no antitrust violation and that they had no duty to deal with their competitors.[49] Further, Trinko argued that under the essential facilities doctrine–a principle that if one market participant controls an essential item to enter a market and refuses to deal with competition, the essential facility holder may be in violation of the Sherman Act–Verizon controlled an essential facility, the telephone lines, and thus violated the antitrust laws.[50] The Court held that the doctrine was inapplicable as Verizon was not considered a dominant firm in the market as there was significant competition.[51]

In the context of Meta and the developing metaverse, the Total Welfare Standard would suggest that all the costs and benefits should be considered. For example, there is currently little to no market on or in any metaverse. If, by allowing Meta to experiment, even at a significant price tag, a market

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45 *See* Jyoti Mann, *Meta Has Spent $36 Billion Building the Metaverse But Still Has Little to Show For It, While Tech Sensations Such As the iPhone, Xbox, And Amazon Echo Cost Way Less,* BUS. INSIDER (Oct. 29, 2022), https://www.businessinsider.com/meta-lost-30-billion-on-metaverse-rivals-spent-far-less-2022-10.

46 *See* Complaint, Meta Platforms, Inc., FTC Docket No. 3:22-cv-04325 (July 27, 2022).

47 *See* Verizon Commc'ns, Inc. v. Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398, 411 (2004) (holding "we do not believe that traditional antitrust principles justify adding the present case to the few existing exceptions from the proposition that there is no duty to aid competitors.").

48 *Id.* at 403.

49 *Id.* at 411.

50 *Id.* at 410.

51 *Id.*

emerges, welfare is certainly gained by both the producers and consumers in that new market. Meta would likely have some monopoly power in the market that develops, perhaps through information, perhaps through fees, or otherwise. Under the Total Welfare Standard, the answer seems straightforward. Meta created something of value, and even though there will likely be some anticompetitive concerns in that market, there is still welfare created; therefore, allowing such a market to develop is warranted as the pie is growing.

This is contrasted by the Neo-Brandeisian/structuralist approach. In the Federal Trade Commission Meta/Within Complaint, there are clear concerns about potential anticompetitive concerns. If the Federal Trade Commission prevails, the result is delayed or halted development of the metaverse in the name of preventing potential anticompetitive behavior in that metaverse. It seems obvious that such a goal is at odds with the antitrust jurisprudence and has not been accepted by any court to date.

III. THE TOTAL WELFARE STANDARD AND BIG TECH

The Total Welfare Standard can succeed where the Consumer Welfare Standard and structural approach cannot, especially in Big Tech, where network effects, platform power, and deep pockets are practically a certainty.

Big Tech is unique in what the firms provide. Take Amazon for example. Amazon not only functions as a marketplace, but also competes in that marketplace and has an almost completely integrated supply chain. Amazon collects data on its platform which enables it to outcompete most of its sellers. For example, in the Amazon market for chairs, Amazon knows at what price point chairs sell at optimally, the optimal design for those chairs, and a slew of other variables that consumers care about when purchasing chairs. Further, Amazon has access to all of the data of its consumers and sellers, but those same consumers and sellers only have a small window into that complete dataset.

This means that if Amazon enters the chair market on their own platform, they are poised to make the optimal product for consumers that will outperform its competition. Further, Amazon can position their products above their competition without cost and use other methods to promote their product above their competition that their competition cannot outcompete. Finally, because of Amazon’s highly integrated supply chain, their cost of producing and delivering their own products will almost invariably be cheaper than their competitions. This means that their competition can likely not compete on price alone as Amazon has a lower marginal cost per unit.

This is similar to app stores like the Apple App Store or the Google App Store. Apple and Google have complete information about what apps are popular, why they are popular, what consumers demand, and how they can outperform their competition if they ever enter the market. For example, think about your iPhone before it had the flashlight integrated into the software. An app, that was either paid for or had ads, was required to use your

camera light as a flashlight. Apple realized the significant demand for such a product through the many sales of the apps and integrated a flashlight into the iPhone operating system. Another example would be the maps app, where initially the Apple Maps app did not have traffic data or reports about accidents or police, but after Apple realized the significant demand generated through competition like Waze, a maps app that allows users to update the map in real time for events like traffic, police, accidents, or otherwise, a similar feature was integrated into the Apple Maps app.

Big Tech has a monopoly on information and control over the platform for which sellers and consumers use their platform. Establishing such a platform is extraordinarily expensive and is unpredictable. The Total Welfare Standard would suggest that, while such expenses may be significant, and there may be potential anticompetitive harms, comparing the net harms with net benefits is what is relevant.

While it certainly is true that many of the current Big Tech firms hold a dominant market position as they currently stand, there is no guarantee that they maintain their position. This may be evidenced by their continued investment into innovation. For example, if Meta/Facebook had a monopoly over their market, it would be unlikely that they would invest tens of billions of dollars into development of a new product for consumers.

Further, extensive research has examined where welfare is captured by innovative products. Schumpeterian profits are defined as those profits that arise when firms are able to appropriate the returns from innovative activity.[52] One study estimated that innovators only capture 4% of the total social surplus from their innovations.[53] Such a conclusion suggests that even the most dominant firms that are innovating are largely contributing to Consumer Welfare, and to a lesser extent, Total Welfare.

One other advantage some Big Tech Firms have is their ability to cross-subsidize. Cross-subsidizing or cross-subsidization is the process of using one arm of a business to fund the development and proliferation of another arm of the same business. For example, Meta was extremely successful in the social media market. Using funds raised by Facebook, Meta can afford its expansion into the metaverse. Cross-subsidization is a very common business practice and antitrust concerns typically don't arise unless the cross-subsidization leads to anticompetitive behavior.

As discussed in Part I.B, the current test for predatory pricing is established by *Brooke Group Ltd v. Brown & Williamson Tobacco Corp.*, where a firm must show below-cost pricing and a dangerous probability of recouping.[54] In the context of Big Tech firms, the large platforms are particularly advantaged in information and their ability to cross-subsidize. For example,

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52 William Nordhaus, *Schumpeterian Profits and the Alchemist Fallacy* 1 (Yale Working Papers on Economic Applications and Policy, Discussion Paper No. 6, 2005).

53 *See id.* at 16–17.

54 509 U.S. 209, 222 (1993).

hypothetically, Amazon could be earning significant profits in the book market and cross-subsidize their Kindle's such that their cost is significantly lower than any other competing ebook reader.[55] This may drive the competitors out of the market.

Chair Khan emphasized this point in her note suggesting that the Chicago School-backed test for predatory pricing was not realistic and that many of the practices seen by Big Tech firms would be considered predatory by any reasonable definition.[56] Under the Total Welfare Standard, Chair Khan's position would be supported. Instead of the current test requiring that predatory pricing cross a significant bar (dangerous probability of recoupment), courts would be inclined to examine all the evidence. The Total Welfare Standard would ensure that neither Type I nor Type II errors would occur in practices that are potentially predatory. For instance, perhaps a firm like Meta charges below cost for their virtual reality headset to draw customers into their metaverse. The first requirement of the *Brooke Group* test would be met as Meta is charging below-cost. But say Meta never planned on recouping those lost earnings through increasing the price of their virtual reality headset. Under the second requirement of the *Brooke Group* test, there is no intent nor dangerous probability of recoupment through increased prices, therefore the practice would not legally be considered predatory. However, let's say it's clear that Meta plans to recoup their investments not through the customers paying directly, but through ad services in the metaverse.

Under the Total Welfare Standard, the concerns that are missed by the *Brooke Group* test, established by the Chicago School, and that are highlighted by the Biden administration can be captured. A judge may look to all the evidence, see that Meta is predatorily pricing, albeit indirectly, and find that the practice is in violation of the Sherman Act. This is the primary benefit of the Total Welfare Standard.

But such concerns are not guaranteed. The reason predatory pricing cases are so rarely brought is because the probability of recoupment is extraordinarily unlikely. As soon as Amazon drives the price of their Kindles up to a sufficient point, their competition that previously left the market will re-enter.

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55 For a more complete analysis of predatory pricing, Amazon, and ebooks, *see* Khan, *supra* note 6, at 774–83.

56 *See* Khan, *supra* note 6, at 730 n.106 (arguing "[a]s some commentators have noted, the Court's reliance on scholarship advocating a retrenchment of enforcement against predatory pricing schemes did not reflect a dearth of opposing views.; *see, e.g.*, F.M. Scherer, *Conservative Economics and Antitrust: A Variety of Influences, in How The Chicago School Overshot The Mark* 30, 33 (Robert Pitofsky ed., 2008) ("Already by the time of the Matsushita decision, there was a substantial scholarly literature documenting what should have passed for predation by any reasonable definition and showing the rationality of sharp price-cutting by a dominant firm to discourage new entrants.")).

IV. ADDRESSING COUNTERARGUMENTS

A. *The Total Welfare Standard is impracticable as courts do not have the knowledge or resources to complete requisite analyses*

In an ideal world, the courts would be able to analyze each potential merger or potentially anticompetitive practice with great scrutiny. The courts would completely consider the costs and benefits of the action itself as well as any implications it may have on other firms. Furthermore, the courts would accurately compare any anticompetitive effects with any procompetitive effects and determine, on aggregate, whether the practice is net beneficial.

For better or worse, we are not in that world. The courts are not only limited in their knowledge, but they are also limited in their resources. The antitrust regime debate fundamentally centers on this discussion. Because courts cannot always embark upon complete analyses,[57] shortcuts must be made that make the task of the judiciary possible. Such debate aligns closely with the rules versus standards debate seen throughout the legal field more generally. As has been discussed above, some of these shortcuts come in the form of rules, like presumptions of illegality. But over time rules generate exceptions.

For example, in the landmark *United States v. Microsoft*, the D.C. Circuit was asked to consider whether Microsoft's practice of tying its internet browser to its operating system was per se illegal, as had been the case with tying arrangements until that point.[58] The court carved out an exception that held tying arrangements involving software platforms should be considered under the rule of reason analysis–not per se illegal. From there, more exceptions have appeared for tying arrangements and the once strong rule of per se illegality has shifted towards a more standards-based approach.

The Biden administration continues to emphasize a return to structuralism. More per se rules prohibit certain mergers or actions.[59] Accounting less for efficiencies or even not accounting for efficiencies in certain situations. Whereas the Consumer Welfare Standard and to a larger extent the Total Welfare Standard emphasize a focus on in-depth analysis by the courts. The Total Welfare Standard specifically emphasizes evaluating everything.[60]

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57 In practice, even complete rule of reason analysis is not complete. The courts have never actually econometrically calculated the relative anticompetitive harms against the procompetitive benefits from a proposed merger or otherwise.

58 *See generally* United States v. Microsoft Corp., 253 F.3d 34, 84 (D.C. Cir. 2001).

59 For example, the FTC recently proposed a rule to ban all non-compete clauses. This is noteworthy because the proposed rule has practically very few exemptions. *See* Non-Compete Clause Rule, 88 Fed. Reg. 3482 (proposed Jan. 5, 2023) (to be codified at 16 C.F.R. 910).

60 The Total Welfare Standard is also commonly referred to as the Aggregate Economic Welfare Standard. *See* Wilson, *supra* note 39.

Practically speaking, United States antitrust law accepts that courts cannot evaluate everything. But as a fundamental principle, it seems logical that if the burden of considering additional evidence or information is less than the value derived from that consideration, the courts should consider such. For example, another rule that arose out of the *Philadelphia National Bank* decision was that not all efficiencies are treated equally.[61]

Revisiting this *Philadelphia National Bank* presumption would be a practical next step in approaching the total welfare standard that better achieves the goals of the Biden administration. Next to the thirty percent market share burden shifting *Philadelphia National Bank* presumption is the out-of-market efficiencies will not be considered for merger analysis *Philadelphia National Bank* presumption.[62] Professor John Yun outlines the debate over considering out-of-market efficiencies and argues that while administrative costs may increase, the costs will not be so burdensome that the costs outweigh the benefits.[63] For instance, out-of-market efficiencies related to a merger are likely closely related to the substantive reasons for that merger. Therefore, while additional documents, depositions, and other evidence will increase, it will not be as significant as collecting a completely new set of documents, et cetera.

Reconsidering such a presumption would allow for more accurate decisions to be made in merger analysis. Instead of considering all the anticompetitive costs and only some benefits of a proposed merger, evaluation of all the anticompetitive costs and *all* the procompetitive justifications would produce welfare maximizing results.

Further, in many cases, a Total Welfare Standard is practical with little change beyond the jurisprudence. For instance, naked price fixing without evidence of efficiencies and many vertical practices, including exclusive dealing or tying arrangements, may be better resolved by the Total Welfare Standard.[64]

However, some argue that the practical import of a change from the current Consumer Welfare Standard to the Total Welfare Standard would not result in significant changes as rarely do judicial decisions lie on the substantive differences.[65]

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61 *See* 374 U.S. 321.

62 *See id.* at 363–64, 370–71.

63 *See generally* John Yun, *Reevaluating Out of Market Efficiencies in Antitrust*, 54 ARIZ. ST. L.J. 1261 (2022).

64 *See* Wilson, *supra* note 39.

65 *See, e.g.*, Herbert Hovenkamp, *Distributive Justice and Consumer Welfare in Antitrust* 9 (U. Iowa Coll. of L. Legal Stud. Rsch. Paper Series Working Paper, 2011) (stating "[t]he volume and complexity of the academic debate on the general welfare vs. consumer welfare question creates an impression of policy significance that is completely belied by the case law, and largely by government enforcement policy. Few if any decisions have turned on the difference."); Heyer, *supra* note 38, at S31 (stating "[t]his is undoubtedly true, and, at least in the United States, courts have not spent much time wrestling with distinctions between consumer and total welfare. This may, however, be partly because federal

B. *The statutory purpose of the Sherman and Clayton Acts were not passed to maximize welfare*

Extensive discussion arises about the statutory and legislative history associated with the Sherman, Clayton, Robinson-Patman, and Federal Trade Commission Acts. One might conclude that the legislation is extensive and therefore looking to the statutory history helps clarify the ambiguities in the statutes. Such a conclusion could not be more inaccurate. The Sherman and Clayton Acts are notorious for being extremely vague.[66]

Because the statutes are extraordinarily indirect in their guidance, the antitrust field is largely guided by common law. Look no further than the *Philadelphia National Bank* presumption or even the Consumer Welfare Standard itself. Nowhere in any antitrust statute is the Consumer Welfare Standard mentioned once.[67] Nonetheless, proponents of each school of thought fervently argue that the statutory and legislative history of each relevant statute clearly supports their propositions. While there are certainly merits to these claims in some instances, such discussion is largely unhelpful given how the antitrust law has developed.

One common argument against a Total Welfare Standard–and more often made against the Consumer Welfare Standard–is that there is no legislative support for such a regime. Pushing back on this argument, the same could be said about the structuralist approach proposed by the Biden administration. While there is historical evidence suggesting that the antitrust laws were meant to prevent anticompetitive conduct, there is limited support suggesting that the antitrust laws were meant to impose arbitrary rules on size of corporations without reference to competition.[68]

Further, US antitrust is a common law field.[69] While there is a statutory scheme, the actual law as applied has been developed through cases and controversies as well as through action brought by the Federal Trade Commission. Therefore, while it may be accurate that the Consumer Welfare Standard or Total Welfare Standard have no explicit backing in the Sherman or

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competition agencies and defendants know that courts are not receptive to defenses when it appears that end users will be harmed."); Herbert Hovenkamp, *Appraising Merger Efficiencies*, 24 GEO. MASON L. REV. 703, 704 (2017) ("[E]fficiency claims . . . are often raised but almost never found to justify a merger that has been shown to be prima facie unlawful. The decisions that credit claimed efficiencies as justification typically also find that the government failed to make out its prima facie case against the merger.").

[66] *See generally* Matthew Sipe, *The Sherman Act and Avoiding Void-for-Vagueness*, 45 FLA. ST. U. L. REV. 709 (2018).

[67] *See, e.g.*, 15 U.S.C. §§ 1—7 (2012).

[68] *See* Yun, *supra* note 63, at 1263 n.7 (quoting Lina Khan & Sandeep Vaheesan, *Market Power and Inequality: The Antitrust Counterrevolution and Its Discontent*s, 11 HARV. L. & POL'Y REV. 235, 277 (2017)) ("Many legal scholars have studied the major antitrust statutes and shown that Bork's argument about efficiency is not supported by the legislative history.").

[69] *See* 15 U.S.C. § 1 (2012).

Clayton Acts' legislative history, there is no mandate for such as supported by the loose language in the antitrust laws.

Such a proposition is supported by the Supreme Court. In *Reiter v. Sonotone*, the Court, relying on Bork's Antitrust Paradox, held that "Congress designed the Sherman Act as a consumer welfare prescription.[70] This was reaffirmed by the 2010 Horizontal Merger Guidelines.[71] For example, in Section 1 of the Horizontal Merger Guidelines, the guidelines state, "[a] merger enhances market power if it is likely to encourage one or more firms to raise price, reduce output, diminish innovation, or *otherwise harm customers* as a result of diminished competitive constraints or incentives."[72]

Further, the reliance on the common law has proven extremely beneficial to the development of antitrust law in line with economic understandings. Perhaps this is the largest problem with accepting a structuralist approach. Time and again, practices that were once deemed unambiguously anticompetitive are shown to have some competitive use. The Total Welfare Standard emphasizes that when a merger or practice is evaluated, the court should look to all of the facts of the case instead of jumping to some conclusion that may ultimately harm welfare and deter innovation and competition.

As a final comment on this topic, the Federal Trade Commission has proposed a rule to ban almost all noncompete clauses.[73] The Federal Trade Commission cites studies that suggest these clauses largely harm competition and the labor market, however the Federal Trade Commission fails to address the fundamental question: if these clauses are so detrimental, why have they not been banned to date and why do so many employers use them? I suspect that noncompete clauses are a tool used by employers to protect their investment into employees.[74] By banning all noncompete clauses, it is foreseeable that unemployment will increase, wages will decrease, and welfare will be harmed.[75] There are certainly instances where such noncompete clauses are

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70 442 U.S. 330, 343 (1979) (internal quotations omitted).

71 *See* Jan Rybnicek & Joshua Wright, *Outside In or Inside Out?: Counting Merger Efficiencies Inside and Out of the Relevant Market*, *in* WILLIAM E. KOVACIC: AN ANTITRUST TRIBUTE – VOLUME II n.8 (Nicolas Charbit et al. eds., 2014) (highlighting "[w]hether efficiencies should be considered in merger evaluations was the topic of much debate in the second half of the last century. Section 7 of the Clayton Act makes unlawful transactions the effect of which "may be substantially to lessen competition." 15 U.S.C. § 18 (2012). The Clayton Act does not expressly provide for the federal courts and antitrust agencies to weigh efficiencies benefits against likely anticompetitive harms when determining whether a proposed transaction violates Section 7. Although consideration of efficiencies benefits was discussed briefly in the first several iterations of the Horizontal Merger Guidelines, it was not until 1997 that the Guidelines detailed how efficiencies should be incorporated into merger analysis in the United States.").

72 *See* U.S. DEP'T OF JUST. & FED. TRADE COMM'N, HORIZONTAL MERGER GUIDELINES, § 1 (2010) (emphasis added).

73 *See* 88 Fed. Reg. 3,482.

74 *See generally* Brandon Long, *Protecting Employer Investment in Training: Noncompetes vs. Repayment Agreements*, 54 DUKE L. J. 1295 (2005).

75 For an in depth discussion, *see* Bruce Kobayashi, *Antitrust, Non-Competition, and No-Poach Agreements in Digital Industries*, THE GLOBAL ANTITRUST INSTITUTE REPORT ON THE DIGITAL

unnecessarily stifling competition and restricting movement in the labor market. Under a Total Welfare Standard, those instances could be addressed independently. The times where the noncompete clauses are used to protect their investment into employees would likewise be considered independently and likely upheld as a legitimate business interest that maximizes welfare.

CONCLUSION

In summary, there are common goals in antitrust. The primary goal is to protect competition in the marketplace. While the Biden administration appears to be interested in a more structural approach to antitrust enforcement, a total welfare standard better comports with the antitrust jurisprudence to date and can accomplish many of the goals of the Biden administration. Maximizing the total welfare of society accounts for both the price and non-price effects of mergers or potentially anticompetitive behaviors on all time horizons. Further, it literally makes the world a better place relative to the consumer welfare standard and the structural approach. Finally, it is practicable to implement. While courts may need to invest more time and resources into deciding antitrust matters, such investment is necessary, especially in the time when many Big Tech firms appear to be dominant in their respective markets.

ECONOMY 707, 715 (2020) (noting "whether the observation of reductions in wages and employee mobility is sufficient to conclude that NCAs are anticompetitive, these results demonstrate that a change in welfare in an input market does not directly map onto a similar change in consumer welfare in the output market, and may be negatively correlated with both consumer and total welfare. Indeed, such a negative relationship will be common when NCAs are used by firms in a procompetitive way to lower costs and increase quality by reducing agency costs. The point is that the procompetitive use of NCAs can result in less mobility and lower wages relative to a setting in which use and/or enforcement of NCAs are prohibited.").