

COMMON AGENCY IN BANK REGULATION

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ABSTRACT

Following the Financial Crisis, regulation requires banks to fund themselves more fully by issuing equity. When a bank fails, deep equity reserves provide a cushion of capital to pay-off depositors and creditors and stop a bank's collapse from causing wider disruption. In requiring banks to build their equity base, however, policymakers have failed to ask a critical question: who supplies this equity funding in practice? In other words, which shareholders are assuming the residual default risk of large and complex banking firms and do these shareholders possess the institutional resilience to absorb the risks they take on? In responding to this question, this Article makes three contributions. First, surveying the 25 largest U.S. banks, the Article shows that U.S. big bank ownership is characterized by an increasing number of blockholders, those holding 5% or more in common equity. Between 2011 to 2016, the number of blockholders at these U.S. banks has increased markedly. In addition, these block stakes are now held, in large part, by the same group of shareholders. The fund managers, BlackRock, Vanguard, Fidelity, State Street Global Advisors and T. Rowe Price – representing retirement and other savings funds – constitute repeat blockholders in U.S. banking.

What does this ownership pattern mean for regulation? This Article's second contribution lies in analyzing how effectively these fund managers can control the extensive bank default risk on their funds' books by using the governance levers available to them as blockholders. This Article terms these fund managers, "common agents," representing their fundholders' interests at multiple large banks. On the one hand, common agents face high information costs in understanding how much default risk their funds are assuming and in agitating for action. Banks are uniquely complex, opaque firms where activism is costly and, thus, relatively rare. On the other hand, fund managers – as common agents – can also prove a positive for regulation. As managers of other people's money, rather than their own, and earning fees rather than a slice of the winnings, fund managers are likely to be less inclined to pursue high-risk profits. Thirdly, recognizing these positive incentives alongside the enormous risk on their

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funds' books, this Article suggests coopting common agents more fully into bank oversight. With multiple block stakes, fund managers can provide a type of "systemic" supervision over the financial system. In proposing this monitoring role for fund managers, this Article aims to draw attention to their position at the frontline of risk management in U.S. financial markets.

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INTRODUCTION

In June 2017, Spain's Banco Popular, the country's fifth largest bank, managed to fail well – vindicating, it seemed, the rules put in place to manage such insolvencies following the 2008 Crisis.¹ Weighed down by a \$100 billion portfolio of bad loans – including toxic mortgages doled out prior to the 2008 Financial Crisis – Banco Popular was sold off to a competitor for the token sum of one euro and handily wound up without much of an effect on the market.² It had lost the confidence of its depositors, who were rushing to withdraw their savings, as well as that of the market, where its share price was plunging.³ With these rapidly deteriorating prospects, authorities triggered regulatory processes that could take the failing bank and wind it up, preventing the sort of chaos seen in the aftermath of the bankruptcy of Lehman Brothers.⁴ Importantly, the losses fell on those who should bear them. Banco's shareholders and those holding securities designed to convert to common equity in a bank collapse, absorbed the cost.⁵ With its common equity worth just one euro's

¹ Gretchen Morgenson, *Lessons from the Collapse of Banco Popular*, N. Y. TIMES, Jun. 23, 2017, at BU1; Matt Levine, *Bank Bailouts and Property Taxes* (Jun. 7, 2017), <https://www.bloomberg.com/view/articles/2017-06-07/bank-bailouts-and-property-taxes> (noting the neat and by-the-book wind-down of Banco Popular); Martin Arnold et al., *Why Santander rescue of Banco Popular is a European Test Case*, FIN. TIMES, Jun. 7, 2017. It should be noted that the Banco Popular wind-down remains the exemplar model of a successful wind-down in Europe. Other notable cases have been less successful. Notably, a number of distressed Italian banks have had to rely on controversial emergency injections of liquidity by the Italian government, including the famed Monte dei Paschi di Siena, reputedly the oldest bank in the world and Italy's fourth largest bank, Rachel Sanderson et al., *Italy Sets Aside \$17bn to Wind-Down Failing Lenders*, FIN. TIMES, Jun. 25, 2017. In late 2016, Deutsche Bank, too, looked like it might be in danger following an adverse judgment by the Justice Department regarding fraudulent activities relating to mis-selling mortgage-backed securities in the run-up to the Crisis, Landon Thomas Jr., *Concern over Deutsche Bank's Health Shakes Markets*, N. Y. TIMES, Sept 29, 2016, at B3; Martin Wolf, *Deutsche Bank Offers a Tough Lesson in Risk*, FIN. TIMES, Oct. 4, 2016. But see, Thomas Hale, *Why Bank Capital Has a Problem*, FIN. TIMES, Jul. 12, 2017 (noting the problems with securities designed to convert to equity close to bank failure, for example, to accelerate collapse).

² Morgenson, *supra* note [1]; Levine, *supra* note [1]; Chad Bray & Jack Ewing, *Santander Rescues Troubled Rival in Test of Europe's New Rules*, N. Y. TIMES, Jun. 7, 2017, at B2.

³ Morgenson, *supra* note [1]; Bray & Ewing, *supra* note [2].

⁴ See e.g., Jeffrey McCracken, *Lehman's Chaotic Bankruptcy Filing Destroyed Billions in Value*, WALL ST. J., Dec., 29, 2008; On contagion following the Lehman Bankruptcy, HAL SCOTT, *CONNECTEDNESS AND CONTAGION: PROTECTING THE FINANCIAL SYSTEM FROM PANICS* (2016); MORGAN RICKS, *THE MONEY PROBLEM* (2016) (arguing that panics constitute a root cause of financial crises, including the 2008 Financial Crisis where panic ensued in the bank-like money market for financial institutions).

⁵ Banco Popular Español SA, Offering Circular for EUR 750,000,000 Additional Tier 1 High Trigger Contingent Convertible Perpetual Preferred Securities (Feb. 5, 2017), <http://www.grupobancopopular.com/ES/AccionistasInversores/EmisionesyRatings/Documents/Sociedades>

at its wind-down, post-Crisis rules seemed to work exactly as planned, ensuring that a major bank's shareholders bore the costs of its bad behavior and prevented risks from spreading to other firms in the financial system.⁶

This near-textbook application of the post-Crisis bank wind-down processes highlights the pivotal role that bank shareholders play as shock absorbers to the financial system. Post-Crisis rules are clear in requiring banks to maintain a thicker cushion of capital, made up much more fully than in pre-2008 years, of funds raised from investors in equity markets.⁷ Buffered by a deeper reserve of this equity capital, banks can operate more safely in good times; as well as have access to funds to pay off depositors, short-term and senior creditors in case of failure.⁸

But with markets placing enormous faith in the capacity of bank shareholders to withstand losses and to preserve financial stability, policy and scholarship have failed to ask critical questions about the real-world implementation of capital regulation.⁹ First, which shareholders are, in

[%20Emissoras/Banco%20Popular%20Espa%C3%B1ol%20SA/Matisse_Banco%20Popular%20Offering%20Circular_FINAL.pdf](#)

⁶ The wind-down of Banco Popular was carried out under the administration of the European Single Resolution Board and the the Single Resolution Fund, designed to offer a pan-European mechanism for winding down failing banks. It forms part of the pan-European bank supervisory system under the auspices of the European Central Bank. Single Resolution Board, Mission, <https://srb.europa.eu/en/mission>.

⁷ Peter Miu et al., *Can Basel III Work? Examining the New Capital Stability Rules by the Basel Committee: A Theoretical and Empirical Study of Capital Buffers* (Feb. 2010, 6-9 https://a1papers.ssrn.com/sol3/papers.cfm?abstract_id=1556446 (providing the historical background to the development of Basel III); Peter Went, *Basel III Accord: Where Do We Go From Here?*, https://a1papers.ssrn.com/sol3/papers.cfm?abstract_id=1693622&rec=1&srcabs=1688594&alg=1&pos=2 (providing an early explication of the rationale grounding the Basel III international reforms. Erik Lüders, Max Neukirchen, and Sebastian Schneider, *Hidden in Plain Sight: The Hunt for Banking Capital*, McKinsey & Company (Jan. 2010), <http://www.mckinsey.com/industries/financial-services/our-insights/hidden-in-plain-sight-the-hunt-for-banking-capital>.

⁸ The Dodd Frank Wall Street Reform and Consumer Protection Act Pub. L. 111–203 H.R. 4173 §202(a); §206 (shareholders are last to be paid out and are thus wiped out). For discussion, David Skeel, *Single Point of Entry and the Bankruptcy Alternative*, Faculty Scholarship Paper 949 (2014), 2-3. It should be noted that commentators have remarked on various drawbacks of Dodd-Frank's Orderly Liquidation Authority. For perspectives, Thomas H. Jackson et al., *Resolution of Failed Financial Institutions: Orderly Liquidation Authority and a New Chapter 11* (April 25, 2011) (proposing that a new Chapter 14 of the Bankruptcy Code be drawn up to offer an alternative to the involuntary OLA process). On management responses to the incentives set up by the OLA, see, pages 1-5-1-6. For an early discussion of approaches to resolving large, failing firms and the Bankruptcy Code, Edward R. Morrison, *Is the Bankruptcy Code an Adequate Mechanism for Resolving the Distress of Systemically Important Institutions*, Columbia Law and Economics Working Paper Number 362 (2009). On using bankruptcy rules to facilitate the use of single point of entry under the OLA, Edward J. Janger & John A.E. Pottow, *Implementing Symmetric Treatment of Financial Contracts in Bankruptcy and Bank Resolution*, Michigan Law and Economics Research Paper No.16-020 (March 2016) (examining the operation of the exemptions from the automatic stay for derivatives trades). John F. Bovenzi, Randall D. Guynn, and Thomas H. Jackson, *Too Big to Fail: The Path to a Solution* (Washington, DC: Bipartisan Policy Center, May 2013.)

⁹ It should be noted that the Trump administration is pursuing a revision of the reforms undertaken in the wake of the Financial Crisis, including revisions to the Orderly Liquidation Authority, set up to provide for the orderly wind-down of large and complex financial institutions. However, even with attempts to dilute or remove the OLA, proposals offered suggest using the U.S. Bankruptcy Code to wind down complex institutions. See for example, House Financial Services Committee, *The Financial Choice Act*, https://financialservices.house.gov/uploadedfiles/financial_choice_act_executive_summary.pdf; U.S.

fact, taking on the residual, default risk of large and complex financial institutions – and how should they manage this risk? And, secondly, do these shareholders possess the institutional resilience to act as a buffer in the event of that a large, complex financial firm fails? In other words, might policymakers have to think twice before triggering a wind-down that forces bank shareholders to absorb significant losses? Put yet another way, will regulators ever wish to protect bank shareholders from the losses they are likely to sustain in a bank failure – to preserve financial stability or for broader reasons of political economy?¹⁰

This Article examines these questions, focusing primarily on the first inquiry: who invests in the equity of the largest and most complex U.S. financial institutions and how might these investors manage the risks they assume? By understanding which actors contract to act as shock absorbers against financial crises, scholars and policymakers will be better positioned to determine their institutional fitness for the task.

This Article makes three contributions: (i) it describes the block shareholding patterns of the largest U.S. banks; (ii) using the results of this survey, it examines how effectively asset managers can manage bank default risk on their funds books using the corporate governance tools at their disposal as blockholders; and (iii) it explores pathways for a more active role for asset managers in bank supervision.

First, I show that, since 2011, immediately following the enactment of the Dodd-Frank Act, the largest U.S. bank holding companies have seen a marked rise in the number of blockholders – those owning more than 5% or more in a bank’s common equity – in their capital

Department of the Treasury, A Financial System That Creates Economic Opportunities, June 2017; Ben Pross & Julie Hirschfield Davis, *Trump Moves to Roll-Back Dodd-Frank Reforms*, N.Y. TIMES, Feb. 3, 2017. Even within a more usual bankruptcy process, shareholders are last to be paid out and are expected to provide the value needed to pay off creditors higher in the priority ladder. This is reflected in the Absolute Priority Rule in bankruptcy, where shareholders only get paid when all other creditor claims are satisfied. There is enormous literature on the Rule, discussions and criticisms of its approach. For discussion, see, for example, Douglas J. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty and the Reorganization Bargain*, 115 YALE L. J. 1930 (2006) (examining the viability of the Absolute Priority Rule and the conditions prompting deviations from the Rule); Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, Vanderbilt University Law School Law and Economics Research Paper No. 01-5 (2001) (noting the drawbacks of a strict adherence to absolute priority and proposing “relative priority”).

¹⁰ For discussion of bailout mechanisms versus the use of the bankruptcy regime, Cheryl Block, *Overt and Covert Bailouts: Developing a Public Bailout Policy*, 67 IND. L. J. 951 (1992) (an early theoretical account of the different forms that bailouts might take, from loans to tax breaks); Kenneth Ayotte & David A. Skeel Jr., *Bankruptcy or Bailouts?* 35 J. CORP. L. 469 (2010) (comparing the advantages of the traditional bankruptcy regime as an alternative to bailouts); Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L. J. 435 (2011); Steven Davidoff Solomon & David Zaring, *Regulation by Deal: the Government’s Response to the Financial Crisis*, 61 ADMIN L. REV. 461, 470-475 (2009) (analyzing the response of the U.S. government to the financial crisis and the different techniques utilized by authorities to re-capitalize failing institutions).

structure.¹¹ Moreover, a small cohort of firms – the fund management companies, BlackRock, Vanguard Group, Fidelity Investments and T. Rowe Price as well as investment firm, Berkshire Hathaway – each dominate as blockholders with multiple such holdings across these large banks. In other words, from 2011 onwards, in the period following the enactment of the Dodd-Frank Act, a group of shareholders has each come to hold the default risk of several major U.S. bank holding companies.

I examine the proxy statements for years 2011 and 2016 of the 25 U.S., bank and financial holding companies that are subject to the Federal Reserve's mandatory stress tests.¹² These stress tests, instituted by the Federal Reserve after the Financial Crisis to test bank resiliency against various doomsday scenarios, are mandatory for a select cohort of the largest and most interconnected of U.S. and foreign-owned bank holding companies operating in the U.S. Out of the 33 bank holding companies stress-tested in 2016, 25 were headquartered in the U.S. and regulated primarily by U.S. regulators; eight were bank holding companies representing subsidiaries of foreign banking organizations. I focus only on the 25 U.S. bank holding companies whose distress and wind-down will be lead by U.S. regulators and be subject to U.S. rules requiring shareholders to principally absorb losses in a bank failure.

Between 2011 and 2016, the number of blockholders at these major U.S. banks rose from an average of 1.45 blockholders in 2011 to an average of 3.04 blockholders in 2016 – a growth of 110%. In 2011, five out of the (then 24) U.S. banks, had no blockholders at all. By contrast, in 2016, each one of the 25 U.S. banks stress-tested by the Fed in 2016 had at least one equity blockholder (24 of these 25 firms had multiple).¹³

¹¹ Alex Edmans & Clifford Holderness, *Blockholders: Theory and Evidence*, Working Paper (Aug. 13, 2016). As Professors Edmans and Holderness note, the definition of what constitutes blockholder can vary. The 5% threshold is generally useful as it is used by the SEC for reporting purposes, requiring those that achieve this level of ownership to mandatorily report their holdings. For discussion on the disclosure regime and its impact on investor incentives to acquire large holdings, Lucian A. Bebchuk and Robert J. Jackson, *The Law and Economics of Blockholder Disclosure*, 2 HARV. L. BUS. REV. 40 (2012).

¹² Federal Reserve stress tests subject banks to simulated doomsday scenarios to determine whether they are able to withstand critical shocks. The Fed focuses on stress testing the most systemically significant banking firms in the U.S. On the Fed's approach and methodology, BOARD OF GOVERNORS OF THE FEDERAL RESERVE, COMPREHENSIVE CAPITAL ANALYSIS AND REVIEW 2016: ASSESSMENT FRAMEWORK AND RESULTS (June 2016). Out of the 33 banks that the Fed stress tested in June 2016 as part of the Comprehensive Capital Analysis and Review (CCAR) program, I do not look at banks whose main base of operations and primary regulators are outside of the U.S. On this basis, out of the 33 companies subject to Federal Reserve stress tests, I do not look at BancWest Corporation, BBVA Compass Bancshares, BMO Financial Corp., Deutsche Bank Trust Corporation, HSBC North America Holdings, MUFG Americas Holdings and Santander Holdings USA. I also do not look at TD U.S. Holdings LLC as this company is not publically traded.

¹³ Fund managers like Vanguard, BlackRock, or Fidelity hold capital within any number of specialized funds organized under the larger umbrella of the "fund brand" such as Vanguard or Fidelity. For a discussion of the implications of separation between the economic ownership and management structure of funds, John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure*

Additionally, during these years, a cohort of fund managers has (markedly) increased their number of block-holdings across these 25 major U.S. banks.¹⁴ In 2011, BlackRock – one of the largest international fund managers – was a blockholder at 10 out of 24 U.S. bank holding companies; Vanguard, the renowned cost-conscious manager of retirement savings, held a block stake in just one out of these 24 banks.¹⁵

By 2016, the picture had changed dramatically. In 2016, BlackRock was a blockholder at 23 out of the 25 U.S. banks; Vanguard at 22. In 2016, other leading fund managers with multiple block stakes comprised Fidelity Investments (7 banks),¹⁶ State Street Global Advisors (8 banks) and T. Rowe Price (4 banks). With the exception of Fidelity, which held block positions at seven banks in 2011, all other managers in this group increased their block positions over time. In 2011, State Street held just one block position and T. Rowe Price did not possess any.

I do not advance any particular causal factor driving the growth of blockholders – as well as the multiplication of block positions across the largest U.S. banks. Still it is not surprising that the enormous pools of capital managed by the likes of BlackRock or Vanguard are deepening their economic engagement to the U.S. banking sector following the Crisis. Pursuant to Dodd-Frank Act, banks are required to maintain far thicker capital buffers – a kind of rainy day reserve of assets that banks must have available to protect themselves and the public against a crisis. To ensure that this buffer comprises value unconditionally at the disposal of banks, post-Crisis regulation sharply increases the proportion that must be made up of funds raised by banks issuing equity. Without a commitment to pay back their shareholders – except for periodic dividends that may be paid when it is safe to do so – banks can rely on a store of value to bolster and preserve their operation.¹⁷

With banks searching for equity funding post-Crisis, nowhere are pools of capital deeper than those managed by top fund managers like BlackRock, Vanguard, Fidelity, State Street, T. Rowe Price and others. BlackRock, for example, boasted over \$5 trillion in assets under management in 2016, Vanguard around \$4 trillion. Asset managers look

and Regulation, 123 YALE L. J. 1228 (2014). See also, John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 YALE L. J. 84, 87, 92-94 (2010) (noting that the mutual fund industry as a whole held assets of around \$11 trillion and comprised 20% of U.S. financial assets and retirement savings).

¹⁴ When referring to BlackRock or Vanguard, investments are made by BlackRock or Vanguard funds that are organized and managed within the umbrella of the larger fund brand. See, Curtis & Morley, *supra* note [13]; Morley, *supra* note [13].

¹⁵ VANGUARD, OUR CLIENTS, <https://about.vanguard.com/our-clients/>.

¹⁶ Fidelity Investments is listed as *FMR LLC*.

¹⁷ See discussion *infra* Part [I(B)(1)].

after and invest the savings of Main Street homes and businesses as well as those of other financial firms that might entrust them to safeguard and invest their surplus cash and securities.¹⁸ That banks should wish to court this source of equity funding is self-explanatory. But asset managers, too, possess strong incentives to invest the capital under their charge in the equity of U.S. banks. Following the Crisis, banks have enjoyed a return to profitability, accompanied by the promise of dividends for shareholders.¹⁹ For asset managers investing in a diversified set of companies, putting capital into bank equity reflects a balanced portfolio, and also makes sense at a time of rising bank prospects. Whatever the cause(s), however, the years since the enactment of the Dodd-Frank Act have seen bank capital structures accommodate more blockholders holding large stakes across a number of banks at once.

So, what does this changing composition of bank shareholding mean for financial regulation? In its second contribution, this Article introduces and develops the concept of “common agency” in bank regulation. By becoming blockholders across multiple U.S. banks, asset managers (or, more accurately, the funds they manage) stand to make great gains if banks perform well. However, these funds also assume the residual default risk of bank failure across a swath of the U.S. financial market. This state of affairs places considerable significance in the ability of asset managers to exercise sound oversight across the multiple banks where their funds are invested. By representing fund-holders across several banks, asset managers exercise a form of “common agency” as they engage in corporate governance to protect the value of fund capital. That is to say, as voting blockholders across many large firms, the U.S. banking system is deeply dependent on the ability of asset managers to represent their funds and to govern effectively. The question of how asset managers exercise their vote on behalf of their funds thus represents an inquiry at the forefront of risk management in financial markets.

¹⁸ VANGUARD, WHO WE ARE: FAST FACTS, <https://about.vanguard.com/who-we-are/fast-facts/> (June 2016); FIDELITY, FIDELITY BY THE NUMBERS: CORPORATE STATISTICS, <https://www.fidelity.com/about-fidelity/fidelity-by-numbers/corporate-statistics> (June 2016); BLACKROCK, ABOUT US, <https://www.blackrock.com/corporate/en-us/about-us> (June 2016); THE ECONOMIST, THE RISE OF BLACKROCK (Dec. 13, 2013); THE ECONOMIST, THE MONOLITH AND THE MARKETS (Dec. 7, 2013).

¹⁹ See Federal Deposit Insurance Commission, Chairman’s Opening Statement Third Quarter 2016 Quarterly Banking Profile, Speech (Nov. 29, 2016), <https://www.fdic.gov/news/news/speeches/spnov2916.html>; Joe Marino, *Big Banks Dial-Up Buybacks after Stress Test Win*, CNBC (Jun. 29, 2016). In the last quarter of 2016, for example, Goldman Sachs reported profits of around \$2.2 billion – up from \$574 billion the year before and reflective of a generally positive performance trend across other large banks. See, for example, Olivia Oran and Richa Naidu, *Goldman Sachs Profit Soars on Bond-Trading Surge*, BLOOMBERG, Jan 18, 2017. On the June 2017 stress tests and approval of dividends, Evelyn Cheng, *Citi Doubles Dividend, Bank Shares Jump after Industry Passes Fed Stress Tests*, CNBC, Jun. 28, 2017.

This Article argues that asset managers – as “common agents” – offer risks as well as benefits for regulation. For a start, bank shareholders face a particularly daunting and costly task when seeking to engage in bank governance. Large and complex banks are near unique in their high degree of informational opacity.²⁰ And understanding the default risk they pose for asset managers (and the funds they represent) necessitates time, analysis and investment in expert resources. As Professors Gordon and Armour write, the corporate governance of banks presents very distinctive challenges relative to other types of company.²¹ Where asset managers are invested across a number of large and complex banks, these costs and complications too, inevitably, multiply.

Moreover, theory has long observed that bank shareholders constitute an especially risk-seeking set of actors. Banks benefit from an explicit public subsidy to support the essential economic functions that they perform.²² The state guarantees the value of bank customer deposits up to a certain amount; banks also enjoy access to emergency funds from the Federal Reserve if they suffer a cash crunch. And, as made evident by the 2008 Crisis, those judged to be “too-big-to-fail” may be given some form of state-directed bailout. With these explicit and implicit sources of state support, theory recognizes that banks generally enjoy lower funding costs relative to other firms.²³

The availability of this safety net can incentivize bank shareholders to behave in ways that are aggressively risk-chasing. Cheap funding can tempt shareholders to push managers towards taking bigger risks that result in handsome profits and dividends.²⁴ The downside is cushioned by the protection offered by the public safety net. Because of this explicit and implicit public assistance, shareholders can underprice risk-taking at banks (relative to how they may price risk at other firms), encouraging them to use governance tools to push for sub-optimal and reckless outcomes.²⁵

Theory might suggest, then, that common agents, with blockholder positions across banks may be especially susceptible to these pernicious incentives. If they succeed, they stand to reap eye-catching gains; the losses, after all, will be partially borne by creditors and the taxpayer.

I suggest, however, that asset managers, as common agents for fund-holders, may offer a safer model of bank shareholder than that

²⁰ See discussion *infra* Part [III(A)(1)].

²¹ Jeffrey Gordon & John Armour, *Systemic Harms and Shareholder Value*, 6 J. LEG. ANALYSIS 35 (2014) (for example, observing that the notion of shareholder primacy is much weaker in banking given that adhering to this notion can result in undue risk-taking by bank managers).

²² See discussion *infra* Part [I(A)(2)].

²³ See discussion *infra* Part [I(A)(2)].

²⁴ See discussion *infra* Part [III(B)].

²⁵ See discussion *infra* Part [III(B)].

conventionally assumed by theory. Importantly, corporate law scholars have long pointed to asset managers – looking after money on behalf of the investing public rather than for themselves – as passive agents in governance.²⁶ Indeed, viewed rationally, they have little incentive to behave otherwise. The likes of BlackRock and Vanguard look after and invest money for others, not for themselves. While earning management fees for their services, the gains and losses they generate through their skills accrue to fund-holders, rather than to themselves.²⁷ Moreover, in offering investment products to the public or to corporations, fund managers like Vanguard claim to hew to practices designed to keep transaction costs (and thus the fees charged to fund-holders) down.²⁸ This cost-conscious approach further dampens the chances of these major fund managers pursuing aggressive, expensive activist tactics in governance.

This passiveness may constitute a major gain for bank regulation. It can offset the motivation of bank shareholders to seek out high-risk pathways for profit. Because of their passiveness and the absence of direct financial skin-in-the game, asset managers as shareholders may pose less of a danger to banking than theory might otherwise presume. Instead of using their block stakes at banks to push for system-wide risk-taking, the tendency of asset managers towards passiveness may attenuate the play of these distorted incentives. Of course, passiveness in governance can itself be a risky strategy. Passive shareholders, for example, may leave managers with too much room to take on bad projects or go along with shareholder proposals offered by aggressive players. Still, a less risk-seeking bank shareholder, with block stakes across the banking system, offers a potential benefit to supervisors looking to strengthen regulation.

Thirdly, this Article concludes by setting out an outline for a proposal to harness the beneficial incentives of common agents in bank governance to better police risk in financial markets. Passive blockholders in U.S. banking, invested across a multiplicity of financial firms, can offer a partial corrective to the costs normally associated with bank corporate governance. By requiring asset managers to more actively supervise large banks, regulation can create a means by which financial markets acquire a type of private “systemic” oversight of the banking sector.

Most importantly, asset managers – as common agents across the banking system – possess a powerful business reason to attend to the exercise of sound corporate governance. If banks fail, then fund holders will likely experience severe losses. Banks might well fail together, as

²⁶ See discussion *infra* Part [II(A)(2)].

²⁷ Morley, *supra* note [13].

²⁸ See discussion *infra* Part [II(A)].

problems spread from one firm to another – exemplified by the chain reactions of collapses seen during the Financial Crisis. In such cases, funds tied to the fate of the financial sector may see deep write-downs in value, forcing Main Street savers to face serious economic damage.

In addition, blockholder common agents are ideally placed to absorb the high costs of bank governance. With large equity investments across several banks, the expenditure in information, analysis and expertise is well spent. Gains can be applied broadly to cover the numerous investments of common agents. Further, blockholders have the power and influence to use this knowledge to effectively lobby management for sound governance outcomes. While asset managers have held equity stakes in banking prior to the Crisis, the growth of block holding arguably amplifies their voting power and behind-the-scenes influence with bank management. To the extent that such asset managers may be less likely to chase risk at banks, and given the exposure of their fund-holders to system-wide bank default risk, it makes sense that they be coopted to a greater degree to perform a private monitoring function for financial markets. In so doing, asset managers – as common agents across banks – can offer a kind of “systemic” oversight of the financial system. While not a substitute for public supervision, a private backstop can offer an added source of reassurance about the health of financial markets.

This proposal has its problems, of course. For a start, asset managers have long adopted a passive role in governance, reluctant to pursue expensive activist strategies at odds with their low-cost funding model. Most worryingly perhaps, encouraging a small cohort of equity investors to collectively supervise the banking industry is likely to face pushback from those concerned about the potential that such co-operation will violate antitrust rules. Antitrust scholars have already sounded the alarm about widespread “common ownership” of U.S. companies by the likes of BlackRock and Vanguard and the negative impact this might have on the quality and price of goods and services.²⁹

²⁹ See in particular, Jose Azar, Martin C. Schmalz & Isabel Tecu, Jose Azar, Martin C. Schmalz & Isabel Tecu, *Anti-Competitive Effects of Common Ownership*, Ross School of Business Working Paper Number 1235 (July 2016), 1-4 (noting the influence of these investors in potentially incentivizing anti-competitive effects in airline companies; Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267(2016) (providing an anti-trust critique of common ownership, focusing on the airline industry); Jose Azar, Sahil Raina & Martin Schmalz, *Ultimate Ownership and Bank Ownership* (July 2016), 46-47, tabl. I, 2-5, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2710252; Eric A. Posner, Fiona M. Scott Morton & E. Glen Weyl, *A Proposal to Limit the Anti-Competitive Power of Institutional Investors*, ANTITRUST L. J. 84 (forthcoming). Commentators have also critiqued this argument. See, for example, Edward B. Rock & Daniel L. Rubinfeld, *Defusing the Antitrust Threat to Institutional Investor Involvement in Corporate Governance*, NYU Law and Economics Research Paper No. 17-05 (Mar. 2017); Matt Levine, *Index-Fund Bans and Hedge-Fund Data*, BLOOMBERG, <https://www.bloomberg.com/view/articles/2016-11-22/index-fund-bans-and-hedge-fund-data>.

I do not venture into this important debate in antitrust economics. Rather, my focus lies squarely on bank capital regulation and the role of asset managers (i.e. their funds) as the main shock absorbers for the financial system. To that end, coopting asset managers more fully into bank supervision makes sense. As block equity holders, they are deeply vulnerable to bank failure. They also have powerful access and influence as common agents in bank corporate governance. Looking forward, this Article constitutes a first step in a longer project to examine the question of who holds the default risk of failure within the financial system and the implications of this allocation. Ultimately, the normative aim of this project lies in addressing the political economy of financial failure to determine whether those who contract to bear the default risk of financial firms, in fact, possess the institutional capacity to do so.

Part I provides an overview of bank regulation to highlight the fragility at the heart of banking and to outline how regulation mitigates this instability. This Part describes the centrality of equity to the post-Crisis regulatory framework as critical buffer for financial risk taking. Part II explores the role of asset managers in banking and sets out the results of the block ownership survey at the largest U.S. banks for the years 2011 to 2016. It shows that these banks now comprise a much larger number of blockholders in their capital structures and that a small number of asset managers constitute repeat blockholders in the U.S. banking system. Part III explores the effectiveness of asset managers to exercise governance at banks as a means to represent and protect the interests of their fundholders. Part IV concludes by offering a blueprint to more fully co-opt asset managers into bank supervision. Part V concludes.

I. BANKS, CONTAGION AND CAPITAL

By design, banks are unique in their capacity to cause widespread economic damage.³⁰ But they are also essential to a well-functioning economy. Traditionally seen, banks take surplus funds from those that have it (depositors) and loan this money out to those that can use it productively (borrowers). They thus occupy a special place in the economy as providers of a public good.³¹ But banks can also fail, causing deep

³⁰ See, for example, RICKS, *supra* note 4, 79-80 (noting the tendency of account holders to redeem when it looks likely that others might do the same).

³¹ STEPHEN G. CECHETTI, MONEY, BANKING AND FINANCIAL MARKETS 38-41 (2008) (noting that a salient feature of banking and financial intermediation lies in taking “surplus units” of capital and loaning it to those that have “deficit units” of need for this money); Gerald Corrigan, *Are Banks Special? A Revisitation*, Fed. Res. Bank of Minneapolis (Mar. 1, 2000); Pauline Skypala, *The Reality Gap in the Role*

economic harm. They might make too many bad loans, prompting depositors to extract their savings in panic. If depositors cannot distinguish one failing bank from another, they might withdraw their money from any number of banks. In draining liquidity from the banking system, a bank collapse severely disrupts the flow of capital from savers to borrowers.³²

The fact of banks being both risky and necessary has given rise to an elaborate body of law designed to make them safer and less prone to crises. Central banks offer distressed banks access to emergency loans; depositors are discouraged from panicking by the promise that their deposits are protected by state guarantee; and regulation requires banks to make sure that they pay for the loans they make and the risks they assume by setting aside a reserve of funds – or bank capital – that can offer extra protection against crises.³³ This Part examines the risks that banks create for financial markets and focuses on the role of bank capital to mitigate them. It highlights the reliance that regulatory policy places on equity as the most desirable type of bank capital. This Part sets the foundation for examining the central inquiry in this Article: with equity so necessary for capital buffers post-Crisis, which investors supply this equity in practice?

A. A Primer on Bank Regulation

The importance of banks for modern economies is matched by the risks they create for markets. Instability lies at the heart of banking.

1. Basics of Bank Function

of Banks, FIN. TIMES, Jun. 15, 2015 (describing the traditional model of banking of banks as intermediaries between savers and borrowers, facilitating credit and money creation). However, this traditional conception of banking is highly simplified and commentators have identified complexities in this model and described various models of banking. For example, commentators note that banks also create deposits when they provide loans and expand the money supply. Professors Omarova and Hockett have also reframed the understanding of banks as intermediaries by focusing on banks as publically franchised to dispense the full faith and credit of the U.S. through the financial system. For more, Zoltan Jakab & Michael Kumhof, *Banks are not Intermediaries of Loanable Capital – and Why This Matters*, Bank of England Working Paper Number 529 (May 2015); Saule T. Omarova and Robert C. Hockett, *The Finance Franchise*, CORNELL L. REV. (forthcoming, 2017). See also, RICKS, *supra* note [4], 79-80 (on the deposit-issuing function of banks, rather than just as deposit takers).

³² RICKS, *supra* note [4], 79-85.

³³ For a summary of the regulatory subsidies accorded to banks, see, Prasad Krishnamurthy, *Regulating Capital*, 4 HARV. BUS. L. REV. 1, 22-23 (2014) (detailing the distortive impact of deposit insurance and lender-of-last-resort funding on the cost of debt funding for banks).

Banks manage the flow of capital in the economy. They create deposits for those that save money. In modern banking, this arrangement takes the form of an on-demand liability on the bank's books. A depositor *loans* its funds to the bank (a liability for the bank) and the bank promises to make these funds immediately available on-demand whenever a depositor wants.

Banks also make loans to those needing capital. By smoothing out the capital needs of homes and businesses, banks can encourage a more efficient flow of money. Homebuyers do not need to save until such time as they have all the cash they need to buy a property – they can take out a loan instead; businesses do not need to keep large amounts of cash to make payroll – so long as they can generate the cash flows needed in future to pay off a loan. If a lender believes that its borrowers are sufficiently creditworthy to make payments on loans over a period of time, banks can bridge funding needs and encourage a productive use of capital.³⁴

The interaction between the deposit-taking and loan-making functions of banks is complex from the standpoint of banking theory. Conventionally, scholars posit a “linear” relationship between the amount of deposits held by a bank and the loans that the bank makes.³⁵ In other words, banks use whatever depositor capital they have to lend, such that banks are always “intermediating” capital flows.

This intermediation model is more complex than first meets the eye. As Professors Jakab and Kumhof observe, banks also “create” deposits when they lend money to a borrower.³⁶ When a bank makes a loan to a borrower, it opens an account and “deposits” the funds in this account for the borrower's use. Banks do not, therefore, debit money from a depositor's account and credit it to the account of the borrower. Rather, banks “create” money by depositing loan funds in a new account. These funds are thus additional to those also available to the depositor. In issuing

³⁴ Douglas W. Diamond & Raghuram G. Rajan, *Liquidity Risk, Liquidity Creation and Financial Fragility: A Theory of Banking*, NBER Working Paper 7430 (1999) (Diamond and Rajan posit that the fragile capital structure underlying banks is necessary for them to perform their social function of mediating liquidity needs cheaply. If investors (depositors) always needed to have direct assurance from borrowers that they could immediately access cash, they would demand tough control rights from a borrower that could provide this reassurance. This transfer of control rights from borrowers to depositors is socially costly and may not be optimal from the point of view of governance). Diamond Rajan also note that the goal of mediating liquidity needs between depositors and borrowers over time helps explain why these two functions are combined in the institution of a bank.

³⁵ John G. Gurley & Edward S. Shaw, *Financial Aspects of American Development*, 45 AM. ECON. REV. 515, 520-21 (1955); John G. Gurley & Edward S. Shaw, *Financial Intermediaries and the Saving-Investment Process*, 11 J. FIN. 257, 258-59 (1956); James Tobin, *Commercial Banks as Creators of Money*, Cowles Foundation Discussion Papers, No. 159. (1963). For discussion, Jakab & Kumhof, *supra* note [31], 2-3; Paul Krugman, *Commercial Banks as Creators of Money*, N.Y. TIMES, Aug. 24, 2013.

³⁶ Jakab & Kumhof, *supra* note [31].

a new loan, a bank acquires an asset on its balance sheet because it is entitled to eventually be repaid on the loan by the borrower.³⁷

In this way, banks can expansively create assets and liabilities on their balance sheets. They do not need to show a direct debit from a saver to a credit on the borrower's books. Instead, banks simply generate a new deposit entry on their ledger and add a corresponding asset to reflect a new source of revenue. As Jakab, Kumhof and Poszar note, without some positive constraint from regulation or the market placing a cost on their abilities to create liabilities and new assets, banks can run up enormous balance sheets in financial markets.³⁸

Provision of Financial Services: The place of banks at the center of deposit-taking and lending activity – with the informational advantages it provides – has supported an expansion in the financial services that banks offer.³⁹ Beyond just taking deposits and providing loans, banks can harness their expertise and access to cheap funding (e.g. through deposits) to provide a range of financial services to a range of clients.

The “universal” banking model – where banks provide a spectrum of financial services – has become the norm in the United States and in Europe.⁴⁰ Through networks of subsidiaries, affiliates and branches,

³⁷ See also, Charles Goodhart, *Whatever Became of Money Aggregates*, Peston Lecture in Honor of Lord Peston, Feb. 28, 2007 (noting the traditional reliance on the theory of banks as intermediaries of capital and suggesting a better model as one where banks create money through lending and the creation of deposits). See also, Omarova & Hockett, *supra* note [31] (pointing to the “franchise” model where banks are franchised to distribute financing ultimately backstopped by the State).

³⁸ Jakab & Kumhof, *supra* note [31]; Zoltan Poszar, *Shadow Banking*, Working Paper (2014).

³⁹ See generally Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209 (2006) (noting that lenders play a powerful role in corporate governance); George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CALIF. L. REV. 1073 (1995) (highlighting the potency of lender signaling for controlling managerial slack); Michael R. Roberts & Amir Sufi, *Control Rights and Capital Structure: An Empirical Investigation*, 4 J. FIN. 1657, 1661-1662 (2009) (showing that lender interventions in governance can have positive economic benefits); Frederick Tung, *Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance*, 57 UCLA L. REV. 115, 119-120; 150-53 (2009) (noting that lenders often receive more information than corporate directors); Charles Whitehead, *The Evolution of Debt: Covenants, the Credit Market, and Corporate Governance*, 34 J. CORP. L. 641, 650 (2009). On the agency costs of delegated monitoring, Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49, 67 (1982).

⁴⁰ Asli Demirgüç-Kunt & Harry Huizinga, *Bank Activity and Funding Strategies: The Impact on Risk and Return*, European Banking Center Discussion Paper No. 2009-01 (2009), 2-4; Saule T. Omarova, *The Merchants of Wall Street*, 98 MINN. L. REV. 265 (2013) (discussing the role of commercial banks in commodities trading and warehousing). In the United States, under the Bank Holding Company Act 1956, the commercial banking and investment banking operations of finance were kept separate, with bank holding companies restricted to performing activities that were within the ambit of the “business of banking.” However, owing to an incremental set of changes and finally the Gramm-Leach-Bliley Act 1999, some bank holding companies could, if also able to be eligible as financial services holding companies, could perform a series of financial services through subsidiaries. Bank Holding Company Act of 1956, Pub. L. No. 84-511, § 4, 70 Stat. 133, 135-37 (1956); 12 U.S.C. §§371c, 371c-1.;12 U.S.C. §§ 1841-1843 (2012). For excellent discussion of the history of the gradual expansion of the scope of “the business of banking” as well as the expansion in the range of services offered by banking firms, Saule T. Omarova, *From Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act*, 89 NC. L. Rev. 1683 (2011).

banking groups routinely include providers of: financial advice, trading services in securities markets, securities underwriting, insurance, payments (e.g. issuing credit cards), lending to other financial firms and so on. Banking firms can also trade for themselves, putting their own capital on the line to invest in markets.⁴¹ A full analysis of the broad services portfolio of modern banking groups is outside the scope of this Article. However, it is worth underlining that banks have dramatically expanded their offerings far beyond the basic model of financial intermediation that undergirds their core function.

Banks have been particularly adept at broadening their scope of activities. They can access credit relatively cheaply, for example, through deposit funds, or the ability to borrow from other financial firms. They enjoy access to emergency funds from the Federal Reserve and protection for retail deposits through deposit insurance.⁴² Scholars have observed that larger banks generally benefit from lower funding costs because of an implicit expectation that regulators will not let such big banks collapse and renege on their debts.⁴³ With this ready access to funds and the provision of a federal safety net, banks can offer financial services at lower costs to themselves than a non-bank. If banks can privately access cheap finance and use this money to sell services at a higher price, they can turn a profit.

⁴¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No.111–203, § 619, 24 Stat.1376 (2010) (Dodd-Frank Act). Dodd-Frank Act § 619(h)(1), 124 Stat. at 1629 (codified at 12 U.S.C. § 1851); Dodd-Frank Act § 619(h)(4), 124 Stat. at 1630. The Dodd-Frank Act prohibits banks from “proprietary trading” which provides a partial check on the bank’s ability to utilize its own funds for making investments. It does not prohibit all aspects of proprietary trading, but defines the prohibition to catch “short term” transactions, and allows for exceptions such as in the case of underwriting or market-making. For a thorough analysis of the Volcker Rule and its effects, Darrell Duffie, *Market Making and the Volcker Rule*, Working Paper (2012), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1990472&rec=1&srcabs=1925431&alg=1&pos=2 (discussing the implications of the Volcker Rule for market making activities for banks); Kimberly D. Krawiec, *Don’t Screw ‘Joe the Plumber,’* The Sausage Making of Financial Reform, 55 *Az. L. Rev.* 53 (2013); Charles K. Whitehead, *Volcker Rule and Evolving Financial Markets*, 1 *HARV. BUS. L. REV.* 39 (2013) (discussing the impact of the Volcker Rule on the growth of shadow banking – the likely update of proprietary trading by non-bank institutions).

⁴² Demirgüç-Kunt & Huizinga, *supra* note [40], 2-6. The authors investigate the impact of a diversified banking approaches and how deposit, non-deposit and wholesale funding from other financial firms impact a bank’s risk-return profile.

⁴³ The literature in this area is extensive. See for example, Andrew G. Haldane, *The \$100 Billion Dollar Question*, BIS Review, no. 40/2010. (2010), <http://www.bis.org/review/r100406d.pdf> (noting that banks appear to show differences in “support ratings” or the perception that banks are likely to receive state support on account of size and market share); Asli Demirgüç-Kunt & Harry Huizinga, *Are Banks Too Big to Fail or Too Big to Save? International Evidence from Equity Prices and CDS Spreads*, World Bank Policy Research Working Paper no. 5360 (2010)(showing that CDS spreads are lower for larger banks); Joao A.C. Santos, *Evidence from the Bond Market on Banks’ Too-Big-to-Fail Subsidy*, FRBNY Economic Policy Review 29 (December 2014) (noting that bond spreads appeared to be smaller for larger banks. Professor Santos’ study of bond spreads between 1985-2009 suggests that larger banks can often see a much lower cost of funding versus smaller banks and non-bank firms). But note that the Government Accountability Office notes that the extent of the funding advantage for larger firms may be growing smaller, *Government Accountability Office, Large Bank Holding Companies: Expectations of Government Support*, GAO-14-621, 11-15 (2014).

The cheaper their own funding costs, the better banks have to compete on the range of services and products that they might be able to offer.⁴⁴

Whether banks should be involved so extensively in the provision of financial services remains a controversial question.⁴⁵ This Article does not enter into this debate. Rather, it points to economic conditions – such as cheaper financing and access to information – that have made it possible for banking firms to adopt a universal model.⁴⁶ Over the last two decades, commercial banks have moved well beyond basic deposit-taking and lending to offer a range of financial services.⁴⁷ The 2008 Financial Crisis also saw the big investment banks, Lehman Brothers, Goldman Sachs, Merrill Lynch, Morgan Stanley and Bear Stearns collapse, become commercial banks or join existing banking groups.⁴⁸ As a result of these transformations, the U.S. is home to some of the largest global banking groups including Bank of America, Citigroup, J.P. Morgan Chase and Wells Fargo that specialize in offering a range of services of which deposit taking and lending constitute just one (usually less profitable) part.⁴⁹ For example, in the third quarter of 2016, major U.S. banking groups saw dramatic revenue gains, owing not to the usual banking functions, but rather because of their role as dealers in global bond markets.⁵⁰ Indeed, in the case of J.P Morgan, its community and consumer banking unit saw

⁴⁴ *But see*, Azar, Raina and Schmalz, *supra* note [29] (noting that common ownership is encouraging anti-competitive behavior by banks in offering more expensive products to customers. However, cheaper funding costs for banks can enable them to theoretically use this funding to offer a range of financial services, though anti-competitive behavior may encourage banks to seek out oligopolistic rents.

⁴⁵ For a historical overview, cross-country comparison and outline of the key policy trade-offs of applying the universal banking model to U.S. banks, Bernard Shull, *The Separation of Banking and Commerce in the United States: an Examination of Principal Issues*, OCC Economics Working Paper 1999-1, 17-20 (1999) (showing that the separation between banking and commerce had been eroding throughout the 1970s and 1980s); See also, Demirgüç-Kunt & Huizinga, *supra* note [40], 2-6 (noting the costs and benefits of universal banking, the advantages of diversification *versus* the risks); Ricardo T. Fernholz & Christoffer Koch, *Why are Big Banks Getting Bigger*, Federal Reserve Bank of Dallas Working Paper 1604 (Feb. 2016) (noting that expansion of banking services into the non-banking area has helped reduce idiosyncratic volatilities in particular asset groups); Adam J. Levitin, *Safe Banking: Finance and Democracy*, 83 U. CHI. L. REV. 387 (2016) (advocating for narrow banking, where banks take deposits and invest this cash in safe assets); Omarova, *supra* note [40].

⁴⁶ Demirgüç-Kunt & Huizinga, *supra* note [40], 2-4.

⁴⁷ Bank Holding Company Act of 1956, Pub. L. No. 84-511, § 4, 70 Stat. 133, 135-37 (1956); 12 U.S.C. §§371c, 371c-1.; 12 U.S.C. §§ 1841-1843 (2012). For a history, Omarova, *supra* note [40].

⁴⁸ Patrick Kingsley, Financial Crisis: Timeline, *GUARDIAN*, 7 August 2012, <https://www.theguardian.com/business/2012/aug/07/credit-crunch-boom-bust-timeline>.

⁴⁹ *See for example*, Beverly J. Hirtle and Kevin J. Stiroh, *The Return to Retail and the Performance of U.S. Banks*, Federal Reserve Bank of New York Staff Reports, no. 233 (2005) (noting that retail banking operations are usually less volatile but less profitable for banks).

⁵⁰ Put briefly, dealers help keep the market running smoothly by mediating trades between buyers and sellers as well as standing ready to buy and sell securities with their own money to keep the markets trading smoothly. This function ensures that markets have liquidity and not suffer from sudden, abnormal price spikes when there is a rush or large demand for securities. For a discussion of how dealer operations, Yesha Yadav, *Insider Trading and Market Structure*, 63. UCLA L. REV. 968 (2016), 981-988.

profits fall by 16%, with provisions made for credit losses of \$1.29 billion, up from \$389 million in 2015.⁵¹

2. The Problem of Banking Design

Instability is a feature of the banking system. Banks mediate temporal fluctuations in demand and supply of cash. Depositors must get their money on-demand; borrowers need to lock-in money for long-term projects. The need to manage these dual tasks – to deliver depositor money on demand and to also finance longer-term loans to borrowers – creates a fundamental and inevitable instability at the heart of banking.⁵² If depositors all need their money back at once, then banks cannot continue lending. And because they have to immediately pay depositors back, banks have to call-in the loans they have made. If banks must call in these loans, borrowers that depend on this capital can lose needed funds.⁵³ The cause of this instability links to two key features of bank function: (i) a temporal mismatch in issuing demand deposits and investing in longer-term borrower debt; and (ii) the potential for irrational panics to trigger sudden depositor demand for a return of their cash.⁵⁴

Banking scholars have devoted extensive study to this instability problem. Professors Diamond and Dybvig point to panic as the major challenge of predicting bank runs and their seriousness. Depositors do not know if they are going to get their money back if a bank looks like it is in trouble. Those that are first in line will be paid; and those that are slower may face uncertainties as to whether their money is safe. This dynamic can prompt depositors to engage in anticipatory withdrawals simply to beat other depositors to the exit at the smallest sign of trouble. Depositors can well be impervious to information in these circumstances. Even if information exists to correct a misperception of risks, depositors might still

⁵¹ Hugh Son, *JPMorgan Earnings Beat Estimates on Bond-Trading Revenue*, BLOOMBERG, Oct. 14, 2016, <http://www.bloomberg.com/news/articles/2016-10-14/jpmorgan-posts-6-3-billion-profit-as-bond-trading-revenue-rises>. See also, Olivia Oran & Sweta Singh, *Morgan Stanley Profit Jumps on Bond Trading Comeback*, REUTERS, Oct. 19, 2016, <http://www.reuters.com/article/us-morgan-stanley-results-idUSKCN12J16C>; Dakin Campbell, *Goldman Sachs Bond-Trading Engine Revs Up to Beat Estimates*, BLOOMBERG, Oct. 18, 2016, <http://www.bloomberg.com/news/articles/2016-10-18/goldman-sachs-profit-rises-47-as-bond-trading-outperforms> (it should be noted that Goldman Sachs, traditionally an investment bank without commercial banking operations before 2008, recently opened an on-line retail banking and lending operation). For discussion, Martin Neil et al., *The Big Four Banks: The Evolution of the Banking Sector*, BROOKINGS, May 26, 2015.

⁵² Diamond & Rajan, *supra* note [34].

⁵³ Diamond & Rajan, *supra* note [34].

⁵⁴ Douglas W. Diamond & Phillip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. POL. ECON. 401 (1983); V.V. Chari & Ravi Jagannathan, *Banking Panics, Information, and Rational Expectations Equilibrium*, 43 J. FIN. 749 (1988).

wish to get their money out. Worse, depositors might well conflate problems at one bank as affecting every bank and rush to claim their money across institutions. Such systemic disorder creates enormous costs for the market - too big for any single firm to control and too large to contain without calling in loans and selling assets at distressed prices.⁵⁵

Regulators have controlled these doomsday scenarios by providing insurance to customers to protect deposits (up to \$250,000 per account) and by giving banks access to emergency funding from the Fed.⁵⁶ Also, the fact of banks being large and diversified might be seen as providing protection against a collapse caused by large-scale depositor flight. If banks are able to derive revenue from multiple business lines, then depositors may be less anxious if one or other were to fail: other sources of revenue could perhaps cushion the blow.⁵⁷ Because of the potential for contagion, troubles at one bank might signal trouble at other banks. In other types of industry (e.g. aviation), a competitor's collapse should be a source of gain for those that remain. In banking, by contrast, the collapse of a major bank may well also push its competitors into distress, provoking a broader system-wide crisis.⁵⁸

B. Banks and Capital Regulation

Bank regulation confronts several problems. First, major banks mediate an array of economic relationships. Secondly, reflecting this significance, regulation offers banks a safety net in the form of deposit

⁵⁵ Diamond & Dybvig, *supra* note [54].

⁵⁶ The Federal Deposit Insurance Corporation (FDIC) provides deposit insurance to protect \$250,000 per customer and account. FEDERAL DEPOSIT INSURANCE COMMISSION, HOW ARE MY DEPOSITS INSURED, <https://www.fdic.gov/deposit/covered/categories.html>. It has been widely noted that this safety net has prevented runs successfully in U.S. banking markets; BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, DISCOUNT WINDOW LENDING, https://www.federalreserve.gov/newsevents/reform_discount_window.htm.

⁵⁷ I do not delve here into risks pertaining to the “shadow banking” system, where firms issue short-term “deposits” to other financial firms and then use these funds to invest in longer-term facilities – creating the kind of temporal mismatch seen in everyday retail banking. For a persuasive and insightful account of the risks of such “money” like arrangements, see, Ricks, *supra* note [4], 10-11. For discussion, Zoltan Pozsar et al., *Shadow Banking*, Federal Reserve Bank of New York Report 458 (2012); Gary Gorton, *Slapped in the Face by the Invisible Hand: Banking and the Panic of 2007*, Federal Reserve Bank of Atlanta 2009 Financial Markets Conference, 2-4 (May 9, 2009). On the repo market, Viktoria Baklanova et al., *Reference Guide to the U.S. Repo and Securities Lending Markets*, Federal Reserve Bank of New York Report 740 (Dec. 2015) (describing the function of the repo market and maturity transformation). On runs in the repo market, see, Manmohan Singh and James Aitken, *The (Sizable) Role of Re-hypothecation in the Shadow Banking System*, IMF Working Paper 10/72 (2010); Gary Gorton & Andrew Metrick, *Securitized Banking and the Run on the Repo*, 104 J. FIN. ECON. 425 (2012).

⁵⁸ See e.g. Natalia Wojcik, *Shares of United Fall for Second Day as Controversy Lingers*, CNBC, Apr. 12, 2017.

insurance and access to emergency Fed funding. Firms can also receive *ad hoc* implicit support in the form of a bailout.⁵⁹ Because of their economic stature, large banks can enjoy reduced funding costs, such that further growth may be more easily fueled by low-cost borrowing. Ultimately, these dynamics create a set of well-recognized bad incentives. An explicit or implicit safety net can motivate risk-taking by a bank, incentivizing reckless lending or expansion into profitable but problematic areas of the market.⁶⁰ Creditors too may be encouraged to lend more freely to a large bank, knowing they will be paid off by regulators or in a bailout.⁶¹

1. The Rationale for Capital Regulation

Regulatory policy has responded to these tensions, in crucial part, by regulating how individual banks design their capital structure relative to the risks they take on.⁶² Regulation seeks to control how banks fund themselves. How much banks borrow, what kinds of securities they invest in, how much unencumbered cash they have and their reliance on equity capital are, in large part, a matter of public policy, not private decision making. The mix of debt-cash-equity in any bank's capital structure is subject to careful regulation to determine whether it helps a bank withstand shocks and prevent bank failure. Capital regulation thus constitutes a touchstone in financial regulation. Indeed, as Professor Tarullo has written, regulating whether a bank's capital structure is adequate to the risks it assumes has come to be "the most important" type of regulation for maintaining financial system safety.⁶³

⁵⁹ Ricks, *supra* note [4].

⁶⁰ Diamond & Dybvig, *supra* note [54], 416-417.

⁶¹ Levitin, *supra* note [10].

⁶² Clearly, capital regulation is a central but by no means the only policy tool available to regulators. For example, bank regulation may target what kinds of activities a bank is qualified to perform. Activity-based restrictions underpin proposals to return banks to narrow banking or to Glass-Steagall Act type restrictions that policed the separation between banking and commercial activity. See, Levitin, *supra* note [45] (justifying a narrow banking approach); Omarova, *supra* note [40] (tracing the erosion of the Glass-Steagall Act and the role of banks in commodity markets); Shull, *supra* note [45] (discussing historical attempts to regulate banking through structural restrictions and as well as geographical restrictions on banking activity through the Riegel-Neal Act. Additionally, regulators might tailor how they supervise banks to better control the risks that banks take on, such as through more consolidation supervision for larger banks. For discussion, Krishnamurthy, *supra* note [33], 3-4 (noting supervision by the Financial Stability Oversight Council as a regulatory tool).

⁶³ DANIEL K. TARULLO, BANKING ON BASEL 15 (AUG. 2008) ("...capital adequacy requirements have become the most important type of regulation designed to protect bank safety and soundness.")

Banks have an especially unusual capital structure by the fact of how they function.⁶⁴ Bank deposits constitute loans to a bank that must be repayable on demand. Because a key source of bank funds represents an on-demand loan to the bank, a bank's capital structure is naturally leveraged. Unlike a normal company that might be entirely funded by its shareholders, banks are creatures of debt as a constituting part of their capital structure. The risk of this debt is controlled, in part, by the availability of deposit insurance and emergency funds.⁶⁵

Counterintuitively, banks make money from the debt they extend to others: e.g. the loans they make to borrowers. These assets generate profits through interest repayments and fees. They can also generate losses. If a bank makes overly-risky loans, then borrowers may not repay. If these losses look like they might imperil the bank's future, then depositors can move quickly to recover their deposits and cause the bank to fail.⁶⁶

Capital buffers provide protection against the instability of a bank's capital structure and the chance that a run might cause insolvency.⁶⁷ As Professor Tarullo notes, capital buffers offer protection against the rapid insolvency of a bank on account of expected losses caused by bad loans. They also provide comfort to those that lend money to banks and that can feel confident about repayment. A reserve of capital should thus help reduce the costs that banks pay to borrow money.⁶⁸

The difficulty lies in calculating how much capital a bank should keep and what assets should count as capital for the sake of the safety buffer. If banks must set aside capital as part of their activities, they are being internalize a compliance cost as part of their business. If a bank perceives these costs as being too high, it might lend less or sell off existing loans to reduce the risks on its books. Reduced lending or a sell-off of loans might dampen the flow of credit and hurt economic activity. Conversely, if the buffer only includes low-quality assets (like junk bonds

⁶⁴ The axiomatic Modigliani-Miller theorem in corporate finance states that the mix of debt-and-equity within a firm does not affect the firm's fundamental value. In the absence of transaction costs like taxation, legal enforceability and so on, whether a company finances itself using debt or equity should not impact its value. Scholars have long debated whether the Modigliani-Miller theorem applies in the case of banking firms. Bluntly put, if it does apply, then increasing bank equity should come at little cost to overall bank profitability. Conversely, if it does not apply, there is an argument for thinking about these varying costs in determining regulatory requirements for bank capital. This Article does not get into the debate of whether the theorem should apply to banks or what the optimal mix of debt-equity should be for capital regulation. For a discussion of the literature, Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958); Sofiane Aboura & Emmanuel Lepinnette, *Do Banks Satisfy the Modigliani-Miller Theorem*, Working Paper (Feb. 2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2348608.

⁶⁵ Krishnamurthy, *supra* note [33], 3-5.

⁶⁶ Michael R. King, *The Cost of Equity for Global Banks: A CAPM Perspective from 1990 to 2009*, BIS Quarterly Review 59 (Sept. 2009).

⁶⁷ TARULLO, *supra* note [63], 16-18.

⁶⁸ TARULLO, *supra* note [63], 16-18.

or volatile currencies) then the safety it offers is illusory. In such cases, the costs that a bank does internalize are insufficient to reflect the risks it takes. A bad capital buffer can transfer the risks of a dangerous bank onto the public purse (that must pay depositors through insurance) as well as to the bank's creditors who are not repaid on what they are owed.

2. Equity Funding in Capital Regulation

Global regulators have long agreed on common standards on how much capital international banks must keep and what kind of capital ought to be included within the buffer.⁶⁹ Since the late 1980s, policymakers have developed and implemented a series of Basel Capital Accords that establish the method by which capital must be calculated and the amount and composition of the capital buffer.⁷⁰ Most recently, this effort has culminated in the Basel III Accord, formulated as part of post-Crisis reform and implemented into U.S. law through the Dodd-Frank Act and the Fed's piece-meal rulemaking.⁷¹ Scholars have written extensively about the Basel Accords and their effectiveness.⁷² This Article does not revisit these debates. Rather, it identifies a marked shift in international capital regulation towards a greater reliance on common equity as an essential part of the protective capital buffer. This focus on common equity capital aligns with concurrent efforts by regulators to ensure that banks are structured to be wound-down without cost to the financial system. As equity buffers grow thicker, their protective cushion should absorb losses and ensure that creditors have value from which they will get repaid.

⁶⁹ Stavros Gadinis and Thom Wetzer, *Basel III: Softer Rules, Harder Institutions* (draft) (unpublished manuscript on file with the author).

⁷⁰ TARULLO, *supra* note [63] (for a history of the Basel rulemaking process and the rationales driving the creation of Basel I and Basel II Capital Accords and the benefits and drawbacks of the Basel approach. On international rulemaking and the "legal" character of international regulatory accords, Christopher J. Brummer, *Soft Law and the Global Financial System: Rule Making in the 21st Century* (2015); Christopher J. Brummer, *Minilateralism: How Trade Alliances, Soft Law and Financial Engineering Are Redefining Economic Statecraft* (2014); Stavros Gadinis, *Three Pathways to Global Standards: Private, Regulatory, and Ministry Networks*, 109 AM. J. INT'L L. 1(2015); Pierre-Hugues Verdier, *The Political Economy of International Financial Regulation*, 88 IND. L. J. 1405 (2012) (analyzing the objectives of international financial regulation and assessing its successes and shortcomings in the framing of its core objectives); Anne-Marie Slaughter & David T. Zaring, *Networking Goes International: An Update*, Washington & Lee Legal Studies Paper No. 2007-12 (2007) (noting the role of international networks in implementing regulatory agreements).

⁷¹ Section 171, Dodd-Frank Act 2010; FEDERAL RESERVE BOARD OF GOVERNORS, BASEL III IMPLEMENTATION, . <http://www.federalreserve.gov/bankinforeg/basel/USImplementation.htm>.

⁷² TARULLO, *supra* note [63]; HEIDI M. SCHOONER & MICHAEL W. TAYLOR, *GLOBAL BANK REGULATION: PRINCIPLES AND POLICIES* (2010).

Calculating Capital: Somewhat counterintuitively, regulators do not look to a bank's liabilities (i.e. deposits) when working out how much capital it should keep – these are underwritten by the public safety net.⁷³ Rather, they look to a bank's assets – the loans that the bank makes. These represent the source of a bank's profits but also the source of risk as bad lending decisions can push a bank towards default.

International regulators are broadly agreed on how to work out the riskiness of bank assets and the capital that banks need to keep. To quantify the riskiness of assets, regulation assigns “a risk rating” to different types of loan. A loan to a developed country should be much less risky than a loan to a start-up company; credit to a top-rated company is less risky than one to a poorly performing one.⁷⁴ The amount of capital that a bank should keep can be determined by reference to this risk-rating and risk-weighting. For example, a \$100,000 loan to a top-rated company might be rated at a risk rate of 20%. Applying the 20% risk-rating, the loan might be seen as having a notional risk-weighted value of \$20,000 – its “riskiness.” The amount of capital that a bank sets aside can be determined as a percentage of the “riskiness” on the bank's balance sheet.

In the case of both Basel I and Basel II, regulators asked that banks set aside capital equal to 8% of all risk-weighted assets on their books. And of this 8%, 4% was required to comprise of so-called Tier 1 (that is, the safest) capital – fully paid up common equity and disclosed reserves. The rest could be made by Tier 2 capital – a wider category of capital that included less safe but viable types of assets like non-disclosed reserves.⁷⁵ Taking the above example, the \$100,000 loan, risk-weighted at \$20,000, would need a bank to keep \$1,600 in capital of which \$800 must be in the form of fully-paid up equity or disclosed reserves.

The first two iterations of the Basel Accords have come in for strident critique – not surprising given their failure to prevent the Crisis. Pre-Crisis capital buffers clearly proved insufficient. As Professor Acharya observes, the six U.S. firms suffering the largest write-downs of their assets saw around \$696 billion worth of losses between March 2007-June 2010. Between June 2007-December 2008, the market value of these six

⁷³ This was not always the case. From 1900-1930s, regulators examined the capital-deposit ratio, YAIR E. ORGLER & BENJAMIN WOLKOWITZ, *BANK CAPITAL* (1977); TARULLO, *supra* note [63] 29-30.

⁷⁴ This methodology largely reflects the blunt Basel I and Basel II foundational Internal Ratings Based approaches, which were fairly crude in establishing “riskiness” for different borrowers depending on the type of borrower (Basel I) or a borrower's credit rating (Basel II). In reality, the larger banks use the Advance Internal Ratings Based Approach, where calculating “riskiness” is determined by sophisticated models of default risks. The example, above, is therefore highly simplified and unlikely to reflect the approach of the large banks. For a discussion of methodology, TARULLO, *supra* note [63], 55-60.

⁷⁵ TARULLO, *supra* note [63], 55-60.

firms was down, on average, by 88% and they veered towards a close or near total collapse, with greater liabilities than equity could support.⁷⁶

Turning to Equity: Post-Crisis financial regulation has turned to equity funding as the solution.⁷⁷

Post-Crisis, scholars and policymakers advocate for thicker capital buffers that are more fully funded by common equity. In influential writings, Professors Admati, deMarzo Hellwing and Pfleiderer have argued for deep and plentiful common equity cushions. They point to past eras of banking practice when equity routinely funded 40-50% of bank business. While the authors stop short of proposing hard benchmarks for the amount of common equity that should be mandated, it is clear that modern-day levels of shareholder equity fall sorely short.⁷⁸ They are not alone. Professors Hanson, Kashyap and Stein, for example, propose the creation of deep counter-cyclical capital buffers that banks build up in good times to maintain their businesses in bad times when downturns deplete the strength of the balance sheet. They, too, highlight the significance of good quality capital as essential, singling out common equity as a major protection against future crisis.⁷⁹ Common equity – rather than preferred stock or even long-term debt – gives banks the best chance of surviving a fallout. The funds raised are readily available, without any commitment to set aside cash for creditors or preferred

⁷⁶ Viral V. Acharya, *The Dodd-Frank Act and Basel III Intentions, Unintended Consequences, Transition Risks, and Lessons for Emerging Markets*, Working Paper (October 2012), <https://www.adb.org/sites/default/files/publication/156247/adbi-wp392.pdf>. See also, Allen N. Berger et al., *How Do Large Banking Organizations Manage Their Capital Ratios?* Working Paper, <http://fic.wharton.upenn.edu/fic/papers/08/0809.pdf> (noting that large U.S. bank holding companies were keeping much higher levels of capital than the requirements under Basel I and Basel II).

⁷⁷ Scott Strah, Jennifer Hynes, and Sanders Shaffer, *The Impact of the Recent Financial Crisis on the Capital Positions of Large U.S. Financial Institutions: An Empirical Analysis*, Working Paper (Jul. 2013) (noting that the capital cushions of major banks depleted rapidly during the Crisis). See also, Acharya, *supra* note [76].

⁷⁸ Anat R. Admati et al., *Fallacies, Irrelevant Facts and Myths in the Discussion of Capital Regulation: Why Bank Equity Is Not Expensive*, Stanford Graduate Sch. of Bus., Research Paper No. 2065 (2011); Anat R. Admati et al., *The Leverage Ratchet Effect*, Rock Center for Corporate Governance at Stanford University Working Paper No. 146 (Oct. 2016) (noting the tendency of shareholders to push for leverage-driven growth); ANAT R. ADMATI & MARTIN F. HELLWIG, *THE BANKERS' NEW CLOTHES: WHAT'S WRONG WITH BANKING AND WHAT TO DO ABOUT* (2013) (noting that 19th century banking relied on shareholder funding to drive lending business, rather than just deposits).

⁷⁹ Samuel G. Hanson, Anil K Kashyap, and Jeremy C. Stein, *A Macprudential Approach to Financial Regulation*, 25 J. ECON. PERSP. 3, 7-9 (2011); See also, Oliver Hart & Luigi Zingales, *A New Capital Regulation for Large Financial Institutions*, 13 AM. L. ECON. REV. 453 (2011) (proposing a new methodology for calculating bank capital that requires banks to maintain equity and long-term debt levels at a high enough level that the credit-default prices on junior long-term bank debt stays above a pre-set level. If this CDS prices rises, banks must issue new equity to reflect the added risk). There remain criticisms of the view that higher capital requirements are necessarily the answer to solve banking crisis. For example, commentators note that the proposals do not fully account for the potential reduction in lending that may follow and a lack of clarity with respect to the objective of bank regulation – saving banks from a crisis or ensuring they are positioned to continue working and lending. For discussion, Krishnamurthy, *supra* note [33] 4-6; Hal S. Scott, *Reducing Systemic Risk Through Reform of Capital Regulation*, 13 J. INTL. ECON. L. 763 (2010).

shareholders. This buffer – rather than being expensive– can reduce their riskiness and funding costs. A reserve of equity can reassure a bank’s funding-providers and help to lower its credit risk and borrowing costs.⁸⁰

Currently, in its third iteration, Basel III imposes higher required levels of common equity, with extra safety buffers and counter-cyclical capital charges mandated for the largest, most systemically significant global banks. Basel III introduces a new category of gold-plated capital – the Common Equity Tier 1 (or CET 1) that focuses only on the value of common equity, the share premium attached to equity as well as retained earnings.⁸¹ Preferred stock is not included within this calculation.⁸² In addition to formalizing common equity as the top-tier capital type, Basel III requires an increase in the Tier 1 and CET 1 buffers for banks. Rather than keep to a thin 4% Tier 1 buffer, Basel III requires that common equity (CET1) alone fund a minimum reserve of 4.5% of risk-weighted assets (RWA) and a capital conservation buffer of 2.5%. Large global banks may also be asked to hold 0%-0.25% CET as part of a countercyclical capital buffer and another 0%-2.5% CET as a charge to account for the risk created by their size and stature. When finally implemented, Basel III should thus cause the largest banking firms to retain a minimum of 12% capital in the form of common equity at the upper end.⁸³ On top of this, Basel III expects banks to keep at least 1.5% of RWA in the form of general Tier 1 assets and a further 2% in the form of Tier 2 assets.⁸⁴

Notably, the Federal Reserve mandates higher-than-Basel CET 1 charges for eight U.S. banking groups designated as being systemically important for global markets (G-SIFI charge).⁸⁵ Rather than charge its banks the Basel III-maximum of 2.5% CET 1 for being large and important, the Fed’s rule permits a higher maximum of between 1%-4.5% CET1 capital for its largest and most impactful constituents. Of the eight designated U.S. banks, J.P. Morgan is set to eventually incur the maximum 4.5% CET1 G-SIFI charge with others paying incrementally lower charges

⁸⁰ Admati et al., *Fallacies*, *supra* note [78], 13-19; Hanson, Kashyap & Stein, *supra* note [79], 17-21 (noting that the impact of higher equity is marginal for bank funding costs because bank riskiness should decrease because of more equity).

⁸¹ Basel III specifies additional criteria as to what counts as CET 1, notably, qualifying minority ownership interests in consolidated depository institutions as well as deductions, such as for goodwill, to seek out a focus on tangible common equity. For discussion, Davis Polk, *U.S. Basel III Final Rule: Visual Memorandum*, July 2013.

⁸² Pricewaterhouse Coopers, *Risk & Capital Management under Basel III* (Feb. 2011), 5-6. It should be noted that non-cumulative, perpetual preferred stock is grandfathered into the category of Tier 1 but not CET 1 capital.

⁸³ Pricewaterhouse Coopers, *Risk & Capital Management under Basel III* (Feb. 2011), 5-6.

⁸⁴ Davis Polk, *U.S. Basel III Final Rule: Visual Memorandum*, July 2013.

⁸⁵ These banks are Bank of America, Bank of New York Mellon, Citigroup, Goldman Sachs, Citigroup, Morgan Stanley, State Street and Wells Fargo. Board of Governors of the Federal Reserve System, Press Release, July 20, 2015, <https://www.federalreserve.gov/newsevents/press/bcreg/20150720a.htm>.

depending on their size and profile. In preparation for this ramping-up of demand for equity, major U.S. banking groups are well on their way to raising the equity necessary to support their business.⁸⁶

Ultimately, capital regulation helps ensure that banks can sustain losses and fail without imperiling the rest of the system. As seen in the chaotic aftermath following the collapse of Lehman Brothers, failing financial firms can cause others around them to risk falling into a similar predicament.⁸⁷ Containing the collapse through capital buffers to absorb losses and orderly liquidation to manage the failure, can dampen panic, prevent fire-selling and preserve asset values.

Post-Crisis reform relies on capital buffers for the orderly resolution of failing firms. Under the Dodd-Frank's Act Orderly Liquidation Authority (OLA), a center-piece of post-2008 regulatory architecture, thick capital buffers are a precondition for the proper functioning of the OLA mechanism.⁸⁸ Under the OLA, equity reserves are essential to absorbing bank losses and to funding the wind-down of a failing bank, until such time as its assets can be sold and restructured.⁸⁹

The innovation of the OLA is the Single Point of Entry (the SPOE) as the functional hinge for the reorganization of a large and complex financial institution. Rather than declare the entire network of subsidiaries and affiliates of a failing firm as being in bankruptcy, only the holding company is placed into an FDIC-guided reorganization and wind-down.⁹⁰ The holding company becomes the "single point of entry" that permits the entire corporate group of the firm to be wound down and restructured. By placing the holding company into bankruptcy, subsidiaries and affiliates can continue their operations and not lose value by virtue of a collapse and sell-off of their assets. In seeking to preserve this going concern value for the firm as a whole, the OLA is designed to contain costly externalities from bleeding into the system. Asset values may be maintained. Sudden

⁸⁶ Pricewaterhouse Coopers, *First-Take: Key Points from the Fed's Final G-SIB Surcharge Rule* (July 22, 2015), <http://www.pwc.com/us/en/financial-services/regulatory-services/publications/assets/final-g-sib-surcharge-rule.pdf>.

⁸⁷ RICKS, *supra* note [4]; Janger & Pottow, *supra* note [8]; Morrison, *supra* note [8].

⁸⁸ See, in particular, Morrison, *supra* note [8]; Ayotte & Skeel, *supra* note [10]. See also, Edward R. Morrison & Joerg Riegel, *Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges*, Columbia Law and Economics Working Paper No. 291 (2006) (an early pre-Crisis examination of the operation of the safe harbors for derivatives contracts under the Bankruptcy Code); Mark J. Roe, *The Derivatives Market's Payment Priorities as Financial Crisis Accelerator*, 63 STAN L. REV. 539 (2011) (noting the role of derivatives safe harbors under the Code in potentially amplifying risk-taking in the financial system).

⁸⁹ Dodd-Frank Act §§ 212(a), 212(c), 204(a) & 206(5) ("creditors and shareholders must bear all losses in connection with the liquidation of a covered financial company.")

⁹⁰ Dodd-Frank Act §§ 202(a) (the process is commenced after agreement between the FDIC, the US Treasury and the Federal Reserve).

runs from the prospect of an immediate insolvency can be forestalled by the assurance that business will continue as normal.⁹¹

Essential to this design is the role of the equity in the operation of the SPOE. The Dodd-Frank is clear in requiring common equity to pay for the wind-down of the holding company.⁹² To the extent that any value remains in the equity of the holding company, it is expected to provide continuity funding for a re-organized bank. In short, common equity faces an extinction event if the OLA is invoked to wind down a large and complex financial institution.

Post-Crisis, common equity constitutes foundation on which safer, more resilient financial institutions are to be grounded. Under Basel III and the Dodd-Frank Act's OLA, common equity constitutes the essential pre-pillar supporting an orderly winding-up of a complex financial institution. Indeed, for a cohort of influential scholars and policymakers, the problem with today's financial system lies not in the fact of this reliance, but rather in its lack of ambition. In other words, existing demands for equity in financial regulation do not go far enough – and banks should raise a bigger capital buffer comprised more heavily of funding from common equity.

II. ASSET MANAGERS AND CAPITAL REGULATION

With increased demands for common equity, capital markets have assumed enormous significance in supplying the resources needed to keep financial markets working. Despite this importance, however, surprisingly little attention has gone into constructing a picture of which investors supply this capital in practice.⁹³ With bank equity investors assuming an essential role in maintaining financial market function, filling in this gap is significant in order to understand who holds the ultimate default risk of financial markets and how effectively they can bear this burden.

This Part has three aims. First, it describes the ownership patterns of the largest 25 U.S. bank holding companies, part of the 33 U.S. and foreign holding companies subject to the Federal Reserve's 2016 stress

⁹¹ The SPOE design has faced numerous criticisms, such as whether or not its actually workable in practice and how it might operate in the event of a subsidiary insolvency, rather than one in which the holding company can be placed in a receivership. For discussion, Skeel, *supra* note [24]; Derrick Cephas & Dimia Fogam, *FDIC Issues 'Single Point of Entry' Resolution Strategy*, Weil, Gotshal & Manges Latest Thinking (March 24, 2014), <http://www.weil.com/articles/fdic-issues-single-point-of-entry-resolution-strategy>; Wilmarth, *supra* note [24].

⁹² Dodd-Frank Act §§ 206(a); 210(b).

⁹³ Azar, Schmalz & Raina, *supra* note [29] (noting high common ownership in banking from the perspective of antitrust policy); Elhauge, *supra* note [29].

tests.⁹⁴ I look at shareholders of over 5% of the common equity of these holding companies (blockholders), as listed in their proxy statements for 2011 and 2016.

This survey shows that the largest U.S. bank holding companies are owned to increasing degrees by blockholders, growing from an average of 1.45 blockholders per bank in 2011⁹⁵ to 3.04 in 2016. Further, these block ownership stakes are concentrated in the hands of a small cohort of asset management companies: BlackRock, Vanguard, Fidelity, State Street and T. Rowe Price. Mr. Warren Buffet's investment firm, Berkshire Hathaway, also ranks as a major owner top U.S. banks. While the causal links driving these trends are complex, a group of asset managers now features as repeat block owners of the largest U.S. banks.

Secondly, this Part provides a descriptive outline of the asset management industry, its function and the general corporate governance practices espoused by its key members. As shown by the survey, asset managers – as block investors across a number of banks – are now critical to the health of financial markets. How they exercise their governance power matters for the safety and soundness of financial system.

Thirdly, this Part lays the groundwork for the argument that asset managers now constitute “common agents” in financial regulation.⁹⁶ By representing the economic interests of fund holders at a number of banking firms, the governance exercised by asset managers has a broad impact. How effectively asset managers perform this task is clearly of considerable significance. It matters not only for the health of financial markets but also for every day savers, who through their fund-holdings, have assumed enormous residual default risk on the U.S. banking system.

A. Asset Management in Banking

1. What is Asset Management?

⁹⁴ Board of Governors of the Federal Reserve, Press Release (June 29, 2016), <https://www.federalreserve.gov/newsevents/press/bcreg/20160629a.htm>.

⁹⁵ This 2011 list does not include Citizens Financial Group, which was a fully-owned subsidiary of the United Kingdom's Royal Bank of Scotland until 2015, when RBOS sold its stake in Citizens. Elizabeth Dexheimer, *RBS Raises \$2.6 Billion Selling Citizens Financial Shares*, BLOOMBERG, Oct 29, 2015.

⁹⁶ This terminology references, in part, the “common ownership” literature, advanced by antitrust economics to describe the widespread ownership of U.S. companies by BlackRock, Vanguard, T. Rowe Price, Fidelity and State Street Global.

Asset managers look after and invest the wealth of savers using a variety of skills and strategies. Instead of individuals setting aside a portion of their monthly wages to invest personally, they can pay a professional asset manager a fee to do so on their behalf.⁹⁷ By pooling the money and assets of millions of savers – both retail and corporate – asset managers cultivate expertise and market power to make investments in capital, currency and other markets.⁹⁸

The kinds of products that asset managers offer their customers are varied and designed to cater to different investment objectives and risk appetites. For example, mutual funds represent the quintessential savings and money management product. Mutual funds pool savings and use this money to invest in diversified portfolios of stocks, bonds and securities. Mutual fund clients can usually redeem the value of their investments by cashing in the “shares” that mutual funds issue to them, representing their particular entitlement within the fund.⁹⁹ Depending on the fund, investors can choose between those that offer a more “active” trading strategy and those that are passive. In the case of active management, managers promise expertise in picking-and-choosing specific stocks or other securities to generate returns for the fund.¹⁰⁰ For passive funds, by contrast, the value of the pool is benchmarked to the performance of a reference basket of securities (like a selected group of stocks in the S&P 500).¹⁰¹ In any event, as a product critical to the long-term economic well-being of tens of millions of mom-and-pop and corporate savers, mutual funds are subject to regulation under the Investment Company Act 1940 (ICA) and by the Securities and Exchange Commission (SEC).¹⁰² Within the parameters laid out by the ICA and overseen by the SEC, asset management companies can offer customers mutual fund products, specifying strategy, likely riskiness and redemption terms. The likes of Vanguard, Fidelity,

⁹⁷ For a more detailed description and analysis of fund organization, see, Morley, *supra* note [13] (noting the significance of the separation of funds and managers as the defining feature investment pools. Morley goes on to discuss the governance implications of this separation).

⁹⁸ For an insightful history and introduction to mutual funds, WILLIAM BIRDTHISTLE, *EMPIRE OF THE FUND: THE WAY WE SAVE NOW* (2016).

⁹⁹ Closed-end mutual funds, in contrast to open-ended mutual funds, do not permit their customers to freely redeem their investment and cash out. Morley, *supra* note [13], 1234.

¹⁰⁰ FIDELITY, WHAT IS A MUTUAL FUND?, <https://www.fidelity.com/learning-center/investment-products/mutual-funds/what-are-mutual-funds>.

¹⁰¹ For example, exchange-traded funds or ETFs usually provide passive management strategies where the value of the fund tracks an underlying index. William A. Birdthistle, *The Fortunes and Foibles of Exchange-Traded Funds: A Positive Market Response to the Problems of Mutual Funds*, 33 DEL. J. CORP. L. 69, 73-85 (2008) (discussing ETFs and their role in the securities market); Andrew Osterland, *Investors Pouring Billions into Passively Managed Funds*, CNBC, 27 June 2016, (noting that in 2015-6, actively managed funds saw a dramatic exit of \$308 billion, while passive funds like ETFs saw \$375 billion in inflows).

¹⁰² Morley, *supra* note [13], 1233-1236; FIDELITY, WHAT IS A MUTUAL FUND?, <https://www.fidelity.com/learning-center/investment-products/mutual-funds/what-are-mutual-funds>.

BlackRock and State Street Global have emerged as specialist mutual fund management companies, offering their customers a choice of funds within which to place their savings.¹⁰³

In addition to mutual funds, asset managers include hedge funds and private equity funds. These firms also pool assets for investment. However, by limiting themselves to a cohort of wealthy investors, hedge funds and private equity funds face a less exacting regulatory environment than mutual funds that expressly cater to a much wider swath of the public. Allowed to deploy a range of strategies, including those that may be too risky for mutual funds, hedge funds and private equity houses can provide asset management for institutions as well as wealthier investors with a higher risk tolerance.¹⁰⁴

As of December 2014, the value of assets in U.S. investment pools came to around \$25.8 trillion.¹⁰⁵ This included \$13.1 trillion in the U.S. mutual fund industry as well as \$3.4 trillion in hedge funds.¹⁰⁶ These numbers, however, tell just a part of the story.

Mutual funds, in particular, tether the wealth of Main Street homes and businesses to the fortunes of global capital markets. An extraordinary amount of U.S. household wealth is entrusted to the management of mutual funds. In all, at end-2015, 44.1% of all U.S. households owned shares in mutual funds, totaling around 54.9 million householders. In the U.S., 93.1 million individuals owned shares in mutual funds. The baby boomer generation, edging closer to retirement, constitutes the demographic with the largest share of mutual fund assets, though younger generations are investing earlier than generations past.¹⁰⁷ These figures point to a dramatic deepening in the relationship between American households and asset management.¹⁰⁸ For example, whereas investment

¹⁰³ For a ranking of top-20 asset managers, Willis Towers Watson, *The World's 500 Largest Asset Managers – Year End 2014* (Nov. 2, 2015), <https://www.towerswatson.com/en/Insights/IC-Types/Survey-Research-Results/2015/11/The-worlds-500-largest-asset-managers-year-end-2014>.

¹⁰⁴ This is not to suggest that hedge funds and private equity funds are not subject to securities regulation. While oversight under the ICA is lowered, owing to a smaller, wealthier clientele, hedge funds remain subject, *inter alia*, to the usual prohibitions against fraud, insider trading, market manipulation and disruption in their trading activities as well as other regulations with respect to how they trade, client funds, disclosure practices. See e.g., Securities and Exchange Commission, Investor Bulletin: Hedge Funds, https://www.sec.gov/investor/alerts/ib_hedgefunds.pdf.

¹⁰⁵ This figure excludes assets in money market mutual funds. Financial Stability Oversight Council, Update on Review of Asset Management Products and Activities, 3-4, <https://www.treasury.gov/initiatives/fsoc/news/Documents/FSOC%20Update%20on%20Review%20of%20Asset%20Management%20Products%20and%20Activities.pdf>. For private funds see, SEC Division of Investment Management, Risk and Examinations Office, Private Fund Statistics, Fourth Calendar Quarter 2014 (Dec. 30, 2015).

¹⁰⁶ Financial Stability Oversight Council, *infra* note [166].

¹⁰⁷ INVESTMENT COMPANY INSTITUTE, FACT BOOK (2016), 2, 9-14, 112-120. See also, INVESTMENT COMPANY INSTITUTE, PROFILE OF MUTUAL FUND SHAREHOLDERS 2008 (2009), 3-27.

¹⁰⁸ E.g. those managing 401(k) defined benefit plans or individual retirement accounts.

companies managed just 2% of all American household financial assets in 1980, they now oversee around 22% of such assets by year-end 2015.¹⁰⁹

Importantly, mutual fund assets¹¹⁰ – managed on behalf of U.S. homes and businesses – are critical investors in the long-term future of corporate America. Most mutual fund assets are invested for the long-term, with 56% of assets placed in long-term equity funds. Around 41% of the 56% of assets held in equity funds were invested in domestic U.S. corporations at year-end 2015.¹¹¹ The tribulations of securities markets thus impact mutual fund performance. In 2008, following the Financial Crisis, mutual funds finished the year managing \$10.3 trillion in assets, a decrease of almost \$2.6 trillion from the year before, as savers pulled their investments and cashed out during the turmoil. With the near 40% decline in stock prices over 2008, U.S. equity mutual funds also found themselves suddenly poorer, leaving the households that invested in them facing deep uncertainty about the future of their 401(k)s and other savings.¹¹²

2. Asset Managers as Institutional Investors

With mutual funds channeling enormous dollar volumes of savings capital into equity and other securities, capital markets have experienced a sharp shift towards a near-complete institutionalization of the investor base. As Professor Zingales notes, whereas only around 10% of all stock market investors in the 1930s were institutions, this figure has risen to over 70% today.¹¹³ In administering large pools of household and other savings

¹⁰⁹ INVESTMENT COMPANY INSTITUTE, FACT BOOK (2016), 11-13. Under the ICI's definition of investment companies, these holdings include assets in exchange-traded funds (ETFs), unit investment trust funds, closed-end funds and mutual funds.

¹¹⁰ This figure includes assets held by mutual funds and exchange-traded funds.

¹¹¹ INVESTMENT COMPANY INSTITUTE, FACT BOOK (2016), 8-9. These figures include assets in Exchange-Traded Funds or ETFs, a generally more passive type of investment vehicle that tracks the performance of underlying indices. For discussion, Morley, *supra* note [13], 1235-6; Birdthistle, *supra* note [111], 71-75.

¹¹² INVESTMENT COMPANY INSTITUTE, FACT BOOK (2009), 8-9 (it is worth noting that, while equity funds suffered losses, there were inflows into fixed-income (debt) orientated funds during the Crisis).

¹¹³ Luigi Zingales, *The Future of Securities Regulation*, Chicago Booth School of Business Working Paper No. 08-27 (2009), 2, 13; Paul G. Mahoney, *The Political Economy of the Securities Act of 1933*, 30 J. LEG. STUD. (2001) (noting the incidence of information-insensitivity and exuberance driving poor investor decision-making); Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, 22 REV. FIN. STUD. 1377, 1388 (2010) (noting that almost 90% of S&P 500 companies include institutional blockholders as part of the ownership structure); Jeffrey N. Gordon, *Employees, Pensions, and the New Economic Order*, 97 COLUM. L. REV. 1519, 1530-50 (1997) (examining the role and influence of pension funds on capital markets and governance); Steve Thel, *The Original Conception of Rule 10b*, 42 STAN L. REV. 385, 390-410 (1990) (describing the growth of U.S. securities markets from largely unsophisticated origins, with investors motivated by quick and easy returns). See also, INVESTMENT COMPANY INSTITUTE, FACT BOOK (2016), 11-13.

through the mutual funds they offer, asset managers make decisions about how and where to invest capital entrusted to their care. In return, they earn management and advisory fees.¹¹⁴ As Professor Morley writes, individual mutual funds are usually members of much larger networks of “fund families” organized, managed and advised under the “brand” of an asset manager like Vanguard, Fidelity or BlackRock. In a public company where a number of its funds might invest, the asset manager represents all funds as the legal shareholder of record holding the votes and decision-making power on behalf of all of its funds.¹¹⁵

The significance of asset managers as shareholders in public markets inevitably draws into relief questions about how they exercise their governance power. As Professors Gilson and Gordon observe, the dominance of these institutional investors in the modern American corporation has diminished the descriptive power of the Berle-Means public company. As Berle-Means famously observed, the Anglo-American corporation is characterized by a dispersed base of shareholders and a resulting agency conflict between managers and the shareholder-owners on whose behalf they run the company.¹¹⁶ By this account, a fragmented group of shareholders will each be poorly motivated to exercise oversight, leaving managers to extract rents at the expense of apathetic investors.¹¹⁷

Gilson and Gordon point to a new dynamic that overlays the conflict-ridden relationship between shareholders and managers. Mutual funds and other investment funds now represent the mainstay investors in public companies. As intermediaries for household and corporate savers, asset managers import a new, more complex interplay of conflicts in corporate governance. The shareholder-manager conflict is still present. In addition, however, Gilson and Gordon also highlight tension between mutual fund managers and their savers. These managers possess limited incentives to agitate on behalf of their savers to exercise active governance of the companies in which saver-wealth has been invested.¹¹⁸

At first glance, this dynamic seems counter-intuitive. Asset managers – by dint of size and the capital they control – possess

¹¹⁴ Morley, *supra* note [13], 1231-33.

¹¹⁵ Morley, *supra* note [13], 1232.

¹¹⁶ Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism*, 113 COLUM. L. REV. 863, 874 (2013). ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 40-75, 110-115 (1967); John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L. J. 1 (2001) (examining the interaction between corporate governance and the quality of capital markets). On greater concentration in capital markets and a survey of the implications for the Berle-Means model of corporate ownership, see also, Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641 (2006)

¹¹⁷ BERLE & MEANS, *supra* note [116], 110-115.

¹¹⁸ Gilson & Gordon, *supra* note [116]. On the separation between funds and managers that might give rise to the conflict, Morley, *supra* note [13].

extraordinary power to agitate for good governance and to reduce the agency conflict between shareholders and corporate managers. Rather than face an uninformed group of apathetic, dispersed investors, corporate managers must now contend with expert, experienced and well-resourced institutions that should be far less vulnerable to opportunistic rent-seeking. Importantly, investors like Vanguard and BlackRock possess real clout. Even though individual funds within a “fund family” might each only own a small portion of the equity in a particular company, the exercise of voting rights occurs at the level of the fund family as a whole. Individual asset managers like Vanguard thus deploy the voting power of all their funds jointly as one entity, rather than as a collection of smaller funds, such that they all generally vote the same way on governance proposals.¹¹⁹

Scholars have devoted considerable study to the behavior of mutual funds as investors at public companies. While this literature is too extensive to be discussed here, a few findings are worth noting. First, though the evidence should point to a motivated and effective group of investors, it is instead more mixed and equivocal in its conclusions. To some degree, this makes sense. Asset managers can agitate for change. But they can also exit their investments. The option to cash out and liquidate their holdings in case of dissatisfaction offers a ready exit that acts as a brake on enthusiastic engagement in governance. Where interventions might require effort, expense and time, exercising the option to sell one’s shares and exit can seem like a more efficient use of fund resources.¹²⁰ Agitation is expensive and legally complex. And, funds tend to diversify, limiting the gains from any single intervention.¹²¹

¹¹⁹ Elhauge, *supra* note [29], 1268; Azar, Schmalz & Tecu, *supra* note [29], 34-35. Angela Morgan et al., *Mutual Funds as Monitors: Evidence from Mutual Fund Voting*, 17 J. CORP. FIN. 914 (2011) (noting that, on management-sponsored proposals, individual firms are likely to vote the same way within the fund family 97.6% of the time; on shareholder-sponsored proposals, there may be greater deviation between funds within the same family. The authors find a greater overall divergence in co-ordination between funds in the same family than other studies); Burton Rothberg & Steven Lilien, *Mutual Funds and Proxy Voting: New Evidence on Corporate Governance*, 1 J. BUS. TECH. L. 157 (2007) (noting an almost 98% commonality in fund votes between fund families).

¹²⁰ Amar Bhide, *The Hidden Costs of Stock Market Liquidity*, 34 J. FIN. ECON. 31 (1991) (noting the option of “exit” as a check on active governance by mutual funds); John C. Coffee, *Liquidity versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991) (monitoring by institutions is diminished where high liquidity enables exit); On the “Wall Street Walk,” see, Anat Admati & Paul Pfleiderer, *The “Wall Street Walk” and Shareholder Activism: Exit as Form of Voice*, REV. FIN. STUD. But see, Pierre Colin-DuFresne & Vyacheslav Fos, *Moral Hazard, Informed Trading and Stock Prices*, Working Paper (2014) (suggesting that liquidity enables the formation of blocks of shareholders and thus encourages corporate governance interventions). The decision about “exit” and “voice” comes in decision-making comes from the seminal work of Albert O. Hirschman, ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY (1970).

¹²¹ For example, some have observed a reliance on advisory firms that provide recommendations to institutional shareholders about how to vote. Proxy firms like Institutional Shareholder Services (ISS), for example, advise shareholders on how best to vote on proposals. Stephen Choi, Jill Fisch & Marcel Kahan, *The Power of Proxy Advisors: Myth or Reality?* 59 EMORY L. J. 869 (2010); James Cotter, Alan Palmiter & Randall Thomas, *ISS Recommendations and Mutual Fund Voting on Proxy*

Importantly, the asset management industry's compensation model further diminishes motivation on the part of fund managers for activism. Fund managers make their money by earning management and transaction fees, rather than a cut of the winnings from investments.¹²² Because they are paid flatter compensation that is also heavily scrutinized and regulated, managers may be less willing to invest in aggressive, active governance. Managers will be paid their regular fee and will not stand to directly earn a slice of any gain that accrues to the value of the investment. Conversely, if investments fail to make money, a manager's reputation might be dented, but she will continue to earn her usual fee.

Secondly, mutual funds, often offer a low cost, low-frills service, particularly in seeking to capture the capital of retail savers. Vanguard, for example, specifically markets itself as a manager appealing broadly to cost-conscious actors. If this effort succeeds, an asset manager increases the dollar volume of assets under its management (and the fees it earns as a result). Savers also gain if they are able to access affordable investment vehicles.¹²³ The low-fee model, however, places a constraint on the scope and intensity of the corporate governance efforts that managers may be willing to perform. Lengthy activist campaigns may be economically unattractive where managers cannot recoup the costs of mounting them from their clients. For fund managers expressly offering a cheap investment product, what managers can charge from their fund holders is likely to be tightly circumscribed. The appeal of mass-market investment products has contributed to the growth of passively managed funds, where returns are benchmarked to a particular index (like the S&P 500). In overseeing passive funds, managers do not routinely buy and sell securities to influence the public companies where they are invested – only adjusting their portfolio at regular intervals to reflect the risk and diversity of their chosen benchmark. Passive funds have proven enormously popular in recent years. Between 1998-2014, the share of equity mutual fund assets held under passively management has grown to 33.5%, tripling in the course of less than two decades.¹²⁴

Proposals, 55 VILL. L. REV. 1, 2-3 (2010) (“We find that mutual funds tend to vote in line with ISS recommendations across the board...mutual funds vote consistently with ISS recommendations more often than do all shareholders.”).

¹²² SECURITIES AND EXCHANGE COMMISSION, MUTUAL FUND FEES AND EXPENSES, <https://www.sec.gov/answers/mffees.htm> (noting that investors in Index Fund A can experience higher returns than those at Index Fund B, if Fund A charges lower fees than B).

¹²³ Vanguard is perhaps most famous for its adherence to a low-cost model of money management, VANGUARD, WHY COST MATTERS, <https://about.vanguard.com/what-sets-vanguard-apart/the-benefits-of-lower-costs/>.

¹²⁴ Ian R. Appel et al., *Passive Investors, Not Passive Owners*, J. FIN. ECON. (forthcoming).

As Professors Gilson and Gordon argue, these industry dynamics push against mutual fund asset managers adopting an active approach to corporate governance. Importantly, competition between top asset managers is unlikely to bridge this motivation gap. If multiple asset managers – like BlackRock, Vanguard and Fidelity – control funds invested in the same company, then activism by one or other manager will lead to gains for other managers too. Also, the activist manager will have to charge its own savers higher fees to reflect the transaction costs of agitation. This means that the active manager loses against its competitors on two fronts: (i) its efforts create returns for its competition as well as for itself; (ii) and its returns to savers are lower because it must charge them higher fees for action.¹²⁵ Unsurprisingly, then, studies suggest that mutual funds have generally played a backseat role in governance, reflecting a kind of strategic, rational passivity.¹²⁶ For example, according to one 2016 industry study on executive compensation, BlackRock supported pay practices 96.3% of the time at its S&P 500 firms.¹²⁷

This picture, however, may be more nuanced.¹²⁸ One study pointed to the important role of “voice” in corporate governance. Rather than perform public acts of activism – such as voting and visible agitation – asset managers may instead engage in backstage interventions. Rather than make displays of their activity, funds may use their power and knowledge to make changes through private engagement with management.¹²⁹ And intriguingly, scholars have also argued that passive managers may still influence corporate management despite their low-cost, passive approach. For example, because they do invest for the long term and do not exercise the option to exit (by selling), managers at passive funds actually have a strong incentive to push for good corporate governance outcomes.¹³⁰ One study further observes that passively managed funds can, in fact, produce results for corporate governance, with their interventions influencing benefits like increased board independence.¹³¹

¹²⁵ Gilson & Gordon, *supra* note [116], 889-895.

¹²⁶ Cotter et al., *supra* note [121], 9-12 (noting that higher legal compliance costs as well as more cynical incentives to curry favor with employer thrifts may have motivated the historically passive governance role played by mutual funds).

¹²⁷ Alexandra Stevenson & Leslie Picker, *A Rare Corner of Finance Where Women Dominate*, N.Y. TIMES DEALBOOK, Jan. 16, 2017 (but noting that BlackRock reported that it had voted against pay packages at 10 out of 50 companies where companies reported the highest pay).

¹²⁸ Morgan et al., *supra* note [119].

¹²⁹ Joseph A. McCahery et al., *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, Working Paper (2015).

¹³⁰ See e.g. Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993).

¹³¹ Appel et al., *supra* note [124].

Nevertheless, historical practices have persuasively pointed to fund managers being generally more passive in their corporate governance than their size and clout would suggest. Gilson and Gordon's argument provides a compelling explanation as to why this might be the case. Fund managers lack sufficient skin in the game to behave in the manner of engaged, activist investors. They thus benefit when more aggressive investors like hedge funds take a lead in surveillance and agitation.¹³²

3. Banking and the Asset Management Industry

BlackRock, Vanguard, Fidelity, State Street and T. Rowe Price have emerged as important investors in banking. These asset managers have utilized the fund capital under their charge to invest in the equity of large U.S. bank holding companies.

It makes sense that asset managers should flex their economic power in the banking industry. Controlling trillions of dollars-worth of assets, asset managers invest widely across the spectrum of American public companies. This is evident in the case of BlackRock – the largest asset manager in the world.¹³³ Founded in 1988, the firm has expanded rapidly to hold a significant place in everyday economic life. In 2016, BlackRock reported managing assets worth over \$5 trillion, up from \$3.5 trillion in 2011.¹³⁴ BlackRock invests in equity-based investments around the world as well as in fixed-income (i.e. debt) securities like bonds, commodities, real property and investment funds.¹³⁵

While smaller than BlackRock, asset managers like Fidelity, Vanguard, State Street Global and T. Rowe Price also control trillions of dollars' worth of capital. Vanguard, the second-largest U.S. asset manager after BlackRock, administers just over \$4 trillion in assets-under-management (AUM) in 2017.¹³⁶ State Street Global Advisors oversaw around \$2.3 trillion in AUM in March 2016; Fidelity held \$2.06 trillion in global AUM and T. Rowe Price around \$812.9 billion dollars in AUM.¹³⁷

¹³² Gilson & Gordon, *supra* note [116].

¹³³ ECONOMIST, *supra* note [18].

¹³⁴ BLACKROCK, ANNUAL REPORT 2015, 2-3; BLACKROCK, ANNUAL REPORT 2011, 10-11. BlackRock notes that growth in the value of assets under management can be ascribed to inflows of new assets, growth in the value of securities already held as well as, *inter alia*, acquisitions.

¹³⁵ BLACKROCK, ANNUAL REPORT 2015, 2-3. Around \$1.25 trillion of AUM is invested in fixed income assets. See also, ECONOMIST, BLACKROCK, THE MONOLITH AND THE MARKETS, Dec. 13, 2013.

¹³⁶ VANGUARD, *supra* note [13].

¹³⁷ THE NORTHERN TRUST, ASSET MANAGEMENT RANKING HIGHLIGHTS (2015), <https://www.northerntrust.com/documents/white-papers/asset-management/rankings-investmgr.pdf>; T. ROWE PRICE, <https://www3.troweprice.com/usis/corporate/en/about.html>; STATE STREET GLOBAL

This cohort of asset managers are major providers of capital to public companies on behalf of household and corporate savers. BlackRock, in particular, appears to be a ubiquitous investor, reportedly holding a stake in almost every single U.S. publically-traded company.¹³⁸ As Professor Einer Elhauge notes, BlackRock, Vanguard, Fidelity, and State Street, together hold of 80% of all stock in S&P 500 corporations.¹³⁹

It is unsurprising that the largest asset managers – custodians of the deepest pools of capital anywhere – should invest in the banking industry. For one, they invest across industries, creating a diverse portfolio of securities in their fund families.¹⁴⁰ Indeed, if asset managers offer funds that simply track an index, like the S&P 500, then large, publically traded banking firms cannot easily be left out of the portfolio. And if finance is profit-generating, a failing by fund managers to take advantage might be seen as breaking a promise to clients that pay fees to professional managers to choose lucrative stocks.

The results of U.S. bank holding ownership data from proxy statements for the years 2011 and 2016, points to an increasing number of blockholders in bank capital structures. Further, it shows that these block stakes are concentrated in the hands of a few major asset managers: BlackRock, Vanguard, State Street Global Advisors, Fidelity and T. Rowe Price. In 2016, for the 25 publically traded U.S. bank holding companies subject to the Fed's 2016 stress-test, 22 out of the 25 firms included both Vanguard and BlackRock as owners of more than 5% of common stock (blockholder). State Street Global featured as a blockholder in eight firms; Fidelity in seven and T. Rowe in four holding companies. In all, BlackRock constituted the most prolific large shareholder, featuring in 23 of the 25 banks studied, with Vanguard close behind in 22 banks.

Contrast these ownership patters with those seen in the 2011 proxy statements. Surveying 24 firms in the proxy statements 2011,¹⁴¹ only 10 bank holding companies listed BlackRock as a blockholder; seven included Fidelity; State Street and Vanguard each appeared as blockholders in only one bank. In 2011, several leading bank holding companies, such as Bank of America or PNC Financial, reported having

ADVISORS, WHO WE ARE, <https://www.ssga.com/global/en/about-us/who-we-are/overview.html>; FIDELITY INVESTMENTS, CORPORATE STATISTICS, <https://www.fidelity.com/about-fidelity/fidelity-by-numbers/corporate-statistics>.

¹³⁸ ECONOMIST, *supra* note [18].

¹³⁹ Elhauge, *supra* note [29], 1268-1269. For an early discussion, David Gilo, *The Anti-Competitive Effects of Passive Investment*, 99 MICH. L. REV. 1 (2000) (noting the anticompetitive costs of passive investors across leading companies).

¹⁴⁰ ECONOMIST, BLACKROCK, THE MONOLITH AND THE MARKETS, Dec. 13, 2013, Table.

¹⁴¹ Citizens Financial, featured in the 2016 list, was a wholly-owned subsidiary of the Royal Bank of Scotland (UK) until 2015.

no large blockholders at all. In 2016 statements, both banks had three large blockholders each, including both Vanguard and BlackRock.

The reasons driving this increase in the higher equity holdings of asset management firms in bank holding companies in 2016 are complex and merit empirical study. I do not make any claim here as to a particular explanatory or causal account regarding this trend.

Still, these five big asset managers – and the funds they represent – constitute critical providers of equity capital to the largest, most complex U.S. banks. Perhaps more importantly, as key block owners at multiple bank holding companies, they each also possess voting and governance power to exercise control of these critically important financial firms.

B. Bank Equity Suppliers: Survey Results

This graph sets out the percentage ownership interests of shareholders with over 5% of equity in publically traded U.S. bank holding companies subject to the Fed's mandatory stress tests for large and complex banks. The information here is taken from the banks' proxy statements for years 2016 and for 2011. A more detailed set of Tables with the detailed percentage ownerships across the 25 banks is in the Appendix. For simplicity, I include information on the five asset managers that appear as blockholders for more than four bank holding companies. For example, Berkshire Hathaway, also holds a number of important investments (e.g. in Amex, Bank of America and Wells Fargo). Further, numerous asset managers also hold block stakes in U.S. banks but less frequently than those included in Table A. Their ownership details are not included here.

Chart A - Ownership Chart 2016 Proxy Statements

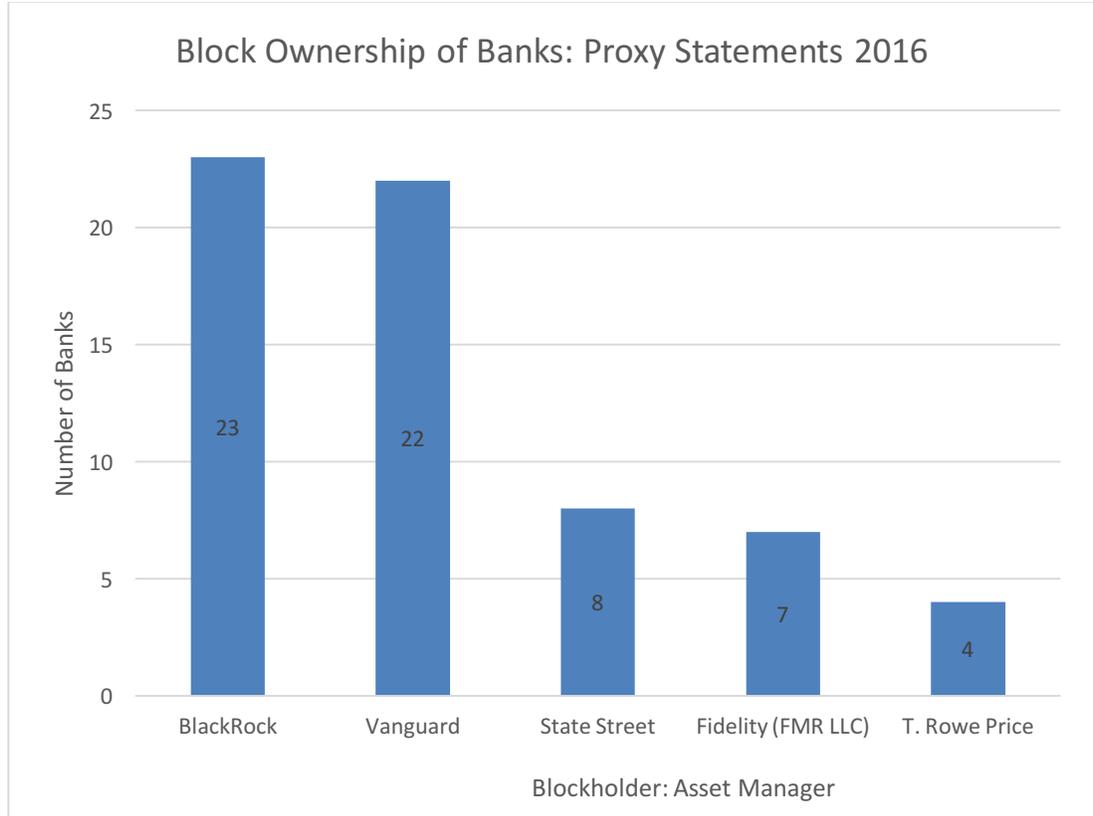
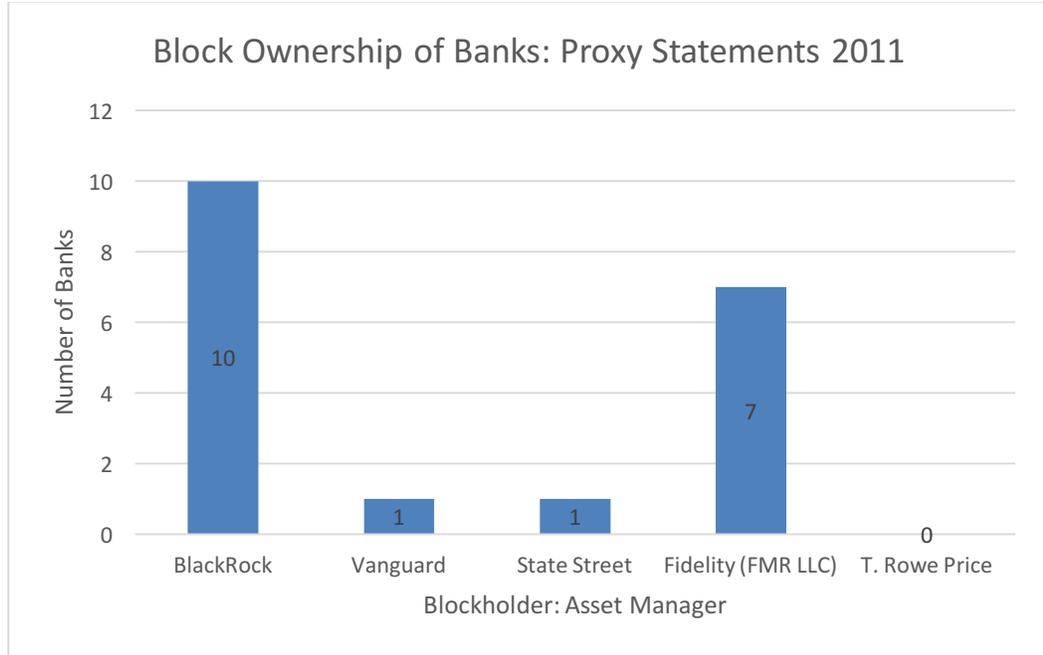
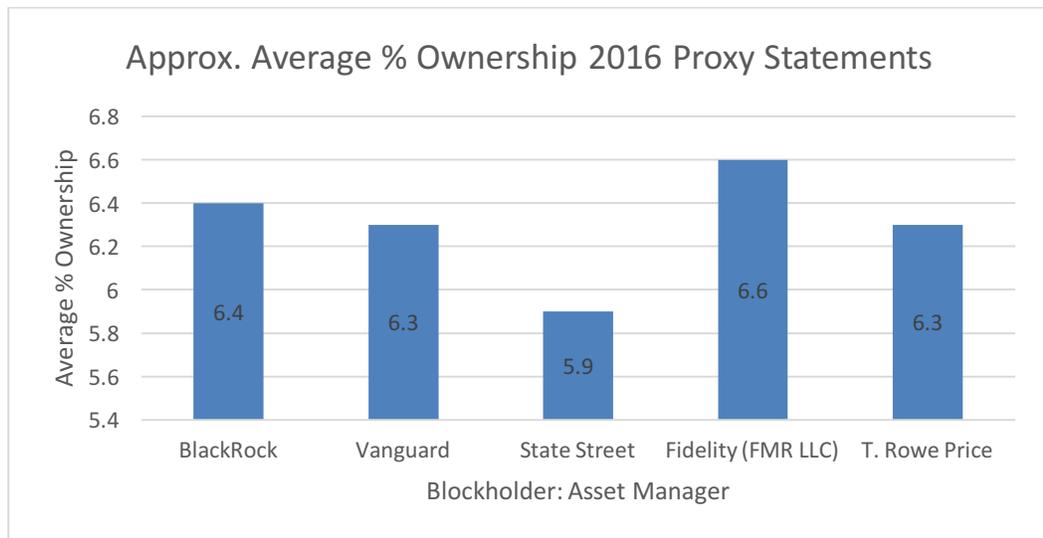


Chart B - Ownership Chart 2011 Proxy Statements**Chart C – Approx. Average % Ownership 2016 Proxy Statements**

III. COMMON AGENCY AND BANK REGULATION

As shown in Parts I and II, Post-Crisis capital regulation places special emphasis on ensuring that bank holding companies fund themselves more fully through equity. In the years since the passage of the Dodd-Frank Act, the real world composition of these capital buffers evidences two telling trends: (i) an increasing number of blockholders at the largest U.S. banks; and (ii) the preeminence of a small group of shareholders as blockholders across multiple major firms in the banking system. With equity key to shoring up the safety and soundness of large banks post-Crisis, these asset-managers have come to occupy a particularly importance place on the front lines of financial risk management.

In turn, public policy also depends on the ability of fund managers to protect their savers from the consequences of risk-taking at the banks where their funds invest. If a bank fails, its shareholders will shoulder the cost. And because banks can often collapse contagiously, potentially afflicting multiple firms, these losses can turn catastrophic.¹⁴² Unlike other types of company, where the fall of big name spells good news for its competitors, the collapse of a large bank is likely to trigger fears of much a wider system-wide failure. For asset managers invested across multiple competing banking firms, then, the demise of one may well portend trouble at others. Even if authorities do not formally trigger wind-down processes, mandating that the value of equity be wiped out to pay off creditors, just the prospect of such an event is likely to depress bank share prices and, as a result, the value of asset managers' fund portfolios.¹⁴³

This Part examines how effectively asset managers might perform their role as shareholders at the banks where their funds are invested. Because they legally represent their funds at numerous large banks at once, asset managers function as a type of "common agent" for savers in the banking system. The financial system is thus deeply impacted by the incentives, skills and shortcomings of asset managers in exercising this governance power as shareholders of record on behalf of fund-holders.

This Part makes the following observations. First, bank governance, particularly at large and complex banks, entails high costs and

¹⁴² Diamond & Dyvbig, *supra* note [54]; Ricks, *supra* note [4].

¹⁴³ See e.g., Eric Dash & Louise Story, *Citigroup Tries to Stop the Drop in Its Share Price*, N.Y. TIMES, NOV. 20 2008, B1.

makes significant resource demands of shareholders. These hurdles can easily dissuade even engaged shareholders from playing a role. Secondly, theory has generally posited that bank shareholders tend to be prone to encourage risk-taking at banks in an effort to secure profits from a bank's access to cheap funding. In this vein, block holders – invested across multiple banks – might be particularly vulnerable to these risk-chasing incentives because they can secure lucrative gains from across the financial system. Thirdly, I suggest, that asset managers can, in fact, prove a boon for bank regulators. As generally passive investors, asset managers may be less moved by incentives to push risk-seeking. Further, they may also be best placed to absorb the large costs of bank governance precisely because they can efficiently apply the gains to govern across multiple firms. These insights anchor the normative proposal advanced in Part IV, exploring a broader regulatory duty to require asset managers to exercise oversight in the financial system.¹⁴⁴

A. Why Bank Governance is Special

Corporate governance matters in financial regulation.¹⁴⁵ But exercising this governance faces unique and costly challenges. As Professors Gordon and Armour observe, banks present a quite unique governance proposition than other types of company.¹⁴⁶ For a start, giving shareholder interests overall primacy, as is conventional in corporate law, sits uneasily with public policy. With banks supported by an explicit public safety net, pursuing shareholder interests at the expense of all else can result in costly consequences for the public purse. Beyond just creating

¹⁴⁴ Certainly, antitrust scholars may be uncomfortable with greater surveillance and control by common owners across multiple competing firms. Further, there are also concerns from the securities law perspective if information from one firm is used to trade in the securities of another.

¹⁴⁵ See notably, Steven L. Schwarcz, *Rethinking Corporate Governance for a Bondholder Financed, Systemically Risky World*, WM. MARY. L. REV. (forthcoming) (arguing for a greater duty to bondholders in financial institutions); Steven L. Schwarcz, *Regulating Corporate Governance in the Public Interest: The Case of Systemic Risk*, Keynote Address, National Business Law Scholars Conference (NBLSC), The University of Chicago Law School June 23, 2016; Steven L. Schwarcz, *Too Big to Fool: Moral Hazard, Bailouts, and Corporate Responsibility*, Working Paper (2016). See also, David Min, *Re-aligning Bank Governance*, Working Paper (on file with the author).

¹⁴⁶ Gordon & Armour, *supra* note [21]. See also, Saule Omarova, *Bank Governance and Systemic Stability: The 'Golden Share' Approach*, 68 ALABAMA. L. REV. 1029 (2017) (noting the significance of executive pay in banking stability and suggesting that a government representative sit on bank boards to represent the public interest); Robert Hockett, *Are Bank Fiduciaries Special*, 68 ALABAMA. L. REV. 1071 (2017) (noting the challenge of applying traditional corporate law paradigms to banking regulation); Lucian A. Bebchuk & Holger Spamann, *Regulating Banker's Pay*, 98 GEO. L. J. 247 (2010). On creditor governance, see for example, Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209 (2006).

a different set of trade-offs for shareholders, banks are also notoriously tricky to understand from the standpoint of how they are run, the risks they assume and how these risks should be priced.¹⁴⁷ To appreciate the default risks faced by shareholders, banks represent a daunting informational challenge generally necessitating deep pockets and expertise to overcome, if it can, in fact, be fully overcome at all.¹⁴⁸

Asset managers – as block holding shareholders common to multiple banks – thus face a complex task in representing their fundholders through corporate governance. Because they represent their funds at multiple banks at once, I term these asset managers, “common agents,” that vote and exercise governance powers widely across the banking system.¹⁴⁹ The stakes are also high. As equity investors across the largest U.S. banks, fund holders can end up facing severe losses in the event of a bank collapse and system-wide crisis.

1. The High Costs of Bank Corporate Governance

High Decision Costs: The transaction costs of exercising corporate governance tend to be especially high for financial institutions. With common agents charged with undertaking corporate governance at multiple banks, these costs multiply in lockstep.

As Professors Mehran and Molineux observe, understanding the measure of these costs must begin with a more fundamental inquiry about what it means to govern a large and complex financial institution: namely, what does a well-governed financial firm actually look like? As Gordon and Armour note, banks cannot simply prioritize shareholder profits. To do so might cause bank managers to place an unduly high premium on risk-taking and on maximizing returns for shareholders at the expense of market stability. As made amply clear by the 2008 Crisis, the price tag for such risk-taking can run into the trillions of dollars, not to mention the ensuing long-term economic damage.¹⁵⁰

At the same time, financial conglomerates like J.P Morgan or Citigroup now perform a multiplicity of functions – beyond just taking deposits and lending. These all require the bank to take risks, to varying

¹⁴⁷ Cotter et al., *supra* note [121]; Choi et al., *supra* note [121].

¹⁴⁸ See discussion *infra* Part [III(A)(1)].

¹⁴⁹ As noted earlier, this term also nods to the term “common ownership” that antitrust scholars use to describe the pattern of large asset managers holding equity stakes across public companies in securities markets.

¹⁵⁰ Hamid Mehran & Lindsey Mollieux, *Corporate Governance of Financial Institutions*, Federal Reserve Bank of New York Staff Reports, no. 539, 11-14 (2012). Ricks, *supra* note [4].

degrees. Large banks extend credit, underwrite securities offerings, facilitate trading in these securities as well provide critical financial infrastructure (e.g. for making payments).¹⁵¹ In seeking to formulate their approaches towards corporate governance, common agents must first decide how much risk a bank should take. While lawmakers have called for an end to “too big to fail” banks and taxpayer funded bailouts, these fuzzily-formulated bounds leave plenty of room for debate and disagreement about what a “good” bank should look like.¹⁵²

With these uncertainties about outcomes in bank governance, shareholders will likely have competing views about how to resolve the tension between a bank’s profit seeking role and its public function. Divergences in perspective between institutional shareholders can contribute to higher decision costs, reflecting the challenges of shareholders coordinating with each other and in deciding on and taking action. In turn, these high decision costs can reduce the motivation of even interested investors to engage in governance. At the very least, they set a threshold at which shareholders will be willing to intervene: shareholders move only when the gains offset the transaction costs involved in any action. Where these costs are high to start with – as in bank regulation – shareholders may be more likely to be rationally apathetic.

Indeed, institutional shareholders – like mutual funds – routinely disagree with one another (and, occasionally, within the fund families themselves) in everyday, non-banking contexts.¹⁵³ In one study of 24 of the largest mutual funds, the authors found agreement among them on certain issues, but divergence on others. While large funds agreed on themes like opposition to antitakeover strategies, variation existed on other topics such as compensation and the degree of deference to be accorded to

¹⁵¹ For an explication of narrow banks, Levitin, *supra* note [45]; See also, Morgan P. Ricks, *Safety First? The Deceptive Allure of Full Reserve Banking*, 83 U. CHI. L. REV. 357 (2016) (noting the challenges for narrow banking for fiscal management and monetary policy); Mehran & Mollineux, *supra* note [150].

¹⁵² On the policy aversion to future bailouts, WHITE HOUSE, WALL STREET REFORM: THE DODD-FRANK ACT, <https://www.whitehouse.gov/economy/middle-class/dodd-frank-wall-street-reform>. On the controversies surrounding optimal riskiness at banks, to cite just one example, there remains considerable debate about whether and to what extent banks ought to invest in the commodity markets, to buy and sell oil or metals. While lucrative, it may result in banks facing large liabilities in case of a natural disaster, or a crash in the price of a commodity. For discussion of policy proposals to reduce bank involvement in commodity markets, Donna Borak & Liz Hoffman, *Fed Targets Big Bank Commodity Lines*, *WALL ST. J.*, Sep, 26, 016; For general discussion, see, Ben S. Bernanke, *Ending “Too Big to Fail:” What’s the Right Approach?* Brookings Research Paper, May 13, 2016 <https://www.brookings.edu/blog/ben-bernanke/2016/05/13/ending-too-big-to-fail-whats-the-right-approach/>; Neel Kashkari, *Lessons from the Crisis: Ending Too Big to Fail*, February 16, 2016 (advocating for a greater focus on breaking up large banks); HAL SCOTT, *supra* note [4] (noting the importance of interconnectedness rather than “bigness” in thinking about systemic risks).

¹⁵³ On disagreement between fund families see, Morgan et al., *supra* note [119].

management.¹⁵⁴ These usual corporate law problems inevitably affect how banks operate as they do other types of company. However, overlaid on these more general disagreements, are considerations about how bank operations impact the riskiness of the firm, its likelihood of needing to access the public safety net and its possible threat to financial stability. The issue of executive compensation for bankers, for instance, offers a prime example an area where corporate governance and financial riskiness intersect. Following the Crisis, policymakers blamed overly-lucrative pay packets and generous performance bonuses as a contributing cause of the collapse.¹⁵⁵ Pursuant to the Dodd-Frank Act, shareholders must now examine the merits of compensation packages from the usual corporate law lens as to whether or not such pay reflects an executive's contribution to corporate growth. But, for banks, this scrutiny also includes deliberation about how any pay packet might affect the bank's behavior as a risk-agent in the market.¹⁵⁶ Such deliberations involve complex considerations. What kinds of risk-taking should be rewarded and punished (e.g. should executives be incentivized to expand into new countries – or, rather, to develop innovative and complex financial products with less familiar risk profiles)? How should pay packets be structured to foster an optimal balance between risk-taking and safeguarding markets (e.g. how should salary claw backs be implemented in case a bank falls into crisis)? With confusion already endemic to concepts like “systemic risk,” working out how a bank's activities might harm other firms and contribute to its risk profile, further adds to the deliberative complexity.¹⁵⁷ Ultimately, this kind of inquiry distills down to fundamentally complex and historically contentious questions about what banks can and should do and how much risks they can safely take. Given these deeper inquiries remain unanswered

¹⁵⁴ Burton Rothberg & Steven Lilien, *Mutual Funds and Proxy Voting: New evidence on Corporate Governance*, Working Paper (2006) (this paper noted large amount of consensus within fund families that tended to vote their proxies as a block. However, it also noted variations between funds as to deference to management. In this study, for example, the authors noted that the five largest funds tended to vote against management 17% of the time on average – the highest being Vanguard (29%) and the lowest being T. Rowe Price (8%). For a literature review of the practices of mutual fund voting patterns, see for example, Morgan et al., *supra* note [119].

¹⁵⁵ Board of Governors of the Federal Reserve System, *Incentive Compensation Practices: A Report on the Horizontal Review of Practices at Large Banking Organizations*, October 2011, <https://www.federalreserve.gov/publications/other-reports/incentive-compensation-report-201110.htm>.

¹⁵⁶ See for example, Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L. J. 247 (2010) (noting the link between high pay at banks and risk-taking in the 2008 financial crisis); Randall S. Thomas et al., *Dodd-Frank's Say on Pay: Will it Lead to a Greater Role for Shareholders in Corporate Governance?* 97 CORNELL L. REV. 1213 (2012) (discussing the implications of the Dodd-Frank Act's “say-on-pay” proposals for shareholder's input into executive compensation packages at banking institutions).

¹⁵⁷ See e.g., Omarova, *supra* note [40], 1031; Hockett, *supra* note [40] (both authors noting and explaining the difficulties of interpreting the term “systemic risk” for the purposes of bank regulation).

and subject differences of views between investors, decision costs for bank corporate governance set an intrinsically high threshold for action.

Indeed, their impact may be especially heavily felt by common agents. As holders of block stakes across numerous firms, asset managers have to reconcile conflicts along two axes: (i) as block holders, a common agent might have several funds within its fund family invested at a large bank. These individual funds might have varying investment objectives (e.g. one may be passively indexed; another actively managed) and disagreements about bank function may arise out of these divergences; and (ii) block holding common agents may reasonably disagree with one another. Holding large economic stakes at large banks, a difference of views among expert investors is likely, if not to be expected.

Information Costs: Information costs can also impact the exercise of bank corporate governance. Large financial institutions present especially steep knowledge gaps.

First, shareholders must wrestle with informational complexity embedded within the organizational structure of financial institutions as well their activities. That large and complex firms defy a clear understanding has become something of a truism after the Crisis.¹⁵⁸ Organizationally, major financial holding companies comprise sprawling networks of domestic and international subsidiaries, affiliates and branches. When Lehman failed in 2008, its collapse implicated 209 subsidiaries in 21 countries that were party to 900,000 derivatives contracts and subject to \$1.2 trillion in creditor claims.¹⁵⁹ Regulatory efforts post-2008 have sought to simplify organizational structures. For example, large banks must now provide regulators with a self-styled “living will,” designed to provide a roadmap through a simulated bankruptcy. Such measures appear to have had some effect in reducing the deep tangle of entities and economic relationships characteristic of large banks before the Crisis.¹⁶⁰ For example, Bank of America – the third largest U.S. bank, as measured by asset size – notes just 19 material entities in its organization.¹⁶¹

¹⁵⁸ Mehran & Mollineux, *supra* note [150], 3-5.

¹⁵⁹ Michael J. Fleming & Asani Sarkar, *The Failure Resolution of Lehman Brothers*, Federal Reserve Bank of New York Policy Review, 175-176 (2014).

¹⁶⁰ Board of Governors of the Federal Reserve, Statistical Release: Large Commercial Banks (Jun. 30, 2016), <https://www.federalreserve.gov/releases/lbr/current/>.

¹⁶¹ The definition of material entities for the living wills resolution provision is narrower and may not have applied to the 209 subsidiaries that were subject to the Lehman Brothers bankruptcy in 2008. In other words, today’s banks may have a greater number of subsidiaries whose operations are not considered sufficiently material to be included within the resolution plan. On the definition of material entity, FDIC, Rules and Regulations, Resolution Plans, § 381.2(j). But the problem is far from fixed. For example, regulators identified “deficiencies” in the the living wills of five leading banks in April 2016, suggesting that concerns about complexity remained live.

But organizational complexity is just one source of the informational deficits faced by asset managers as bank shareholders.¹⁶² Gaining insight into bank activities, business lines and assets still represents a challenge despite efforts to simplify corporate structures.¹⁶³

Importantly, even with a more intensive regulatory regime following the Dodd-Frank Act, the largest banks in the U.S. have grown steadily in size, as measured by the value of their assets. Together, Bank of America, Citigroup, Wells Fargo, J.P. Morgan Chase and Goldman Sachs held around \$8.6 trillion in assets in 2011, equivalent then to 56% of the U.S. economy and up by 43% from 2008.¹⁶⁴ In 2016, this figure had risen to approximately \$9 trillion, slowing since 2011, but nevertheless pointing to bank balance sheets of enormous economic heft and complexity.¹⁶⁵

Table C – Total Assets Commercial Banks



¹⁶² Board of Governors of the Federal Reserve System & Federal Deposit Insurance Corporation; Resolution Plan Assessment Framework and Firm Determinations, 3-4 (April 13, 2016); Ryan Tracy, *Regulators Reject 'Living Wills' of Five Big U.S. Banks*, WALL ST. J., April 12, 2016.

¹⁶³ See also, the Volcker Rule that was designed to reduce proprietary trading by bank as well as to limit direct bank sponsoring of hedge funds. Dodd-Frank Act, Section 619; For discussion, see, Whitehead, *supra* note [41].

¹⁶⁴ David J. Lynch, *Big Banks, Now Even Too Bigger to Fail*, BLOOMBERG, April 19, 2012.

¹⁶⁵ The figures for 2016 were taken from the living wills submitted by these five biggest banks to regulators as part of their compliance obligations under the Dodd-Frank Act.

The activity and asset compositions of the largest U.S. banks pose high hurdles for shareholders seeking to understand how much risk financial firms are assuming as a precursor to governance. To understand a bank's default risk, its capital base as well as the overall viability of its business, shareholders must undertake a resource-intensive task into the quality of opaque, generally illiquid bank loans, a bank's underwriting and trading activities, involvement within infrastructure as well as international operations. Such investigations invariably require investors to deploy time, expertise and analytical resources to the task. Indeed, evident in the multiplicity of specialist federal regulators charged with supervising a large bank, oversight requires monitors to access detailed, varying information and to take a full 360 degree view of its activities.¹⁶⁶

This is not to suggest that institutional investors are bound to fail at this task. In one early study, for example, Professor Flannery notes that investors were able to price equity securities of a banking firm about as well as they did for a non-banking one.¹⁶⁷ But the difficulties of valuing opaque and often illiquid assets like loans make studying banks and their riskiness a particularly difficult and costly task. In another (pre-Crisis) study on the ease of measuring default risk, the authors noted that ratings by Moody's and Standard and Poor's differed most from each other when examining banks and insurers. The higher the proportion of a bank's assets were focused on loans, the more these ratings diverged.¹⁶⁸ In other words, ratings agencies struggled to arrive at a consistent interpretation of bank riskiness, particularly for larger banks holding more loans on their balance sheets. These differences of opinion suggest that understanding complex bank balance sheets is far from an easy task, that can leave even seasoned experts fumbling. And as made clear during the Crisis, valuing credit risk can be especially tricky to get right when financial engineering enables such risk to be sliced, diced and traded between financial firms.¹⁶⁹

Secondly, acquiring information is neither easy nor cheap in matters concerning bank safety and soundness.¹⁷⁰ In contrast to securities

¹⁶⁶ See for example, FINANCIAL STABILITY OVERSIGHT COUNCIL, DESIGNATIONS, <https://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx>.

¹⁶⁷ Mark J. Flannery & Joel Houston, *The Value of a Government Monitor for U.S. Banking Firms*, 31 J. MONEY, CREDIT AND BANKING 14 (1999).

¹⁶⁸ Donald Morgan, *Judging the Risks of Banks: What Makes Banks Opaque*, Federal Reserve Bank of New York Staff Report 98-04 (1998).

¹⁶⁹ See for example, Adam Ashcraft & Till Scheurmann, *Understanding the Securitization of Sub-Prime Credit*, Federal Reserve Bank of New York Staff Report 318 (2008).

¹⁷⁰ Mehran & Mollieux, *supra* note [150].

regulation, that emphasizes disclosure and transparency, banking has traditionally – and for good reason – favored a more discrete approach.

To help investors seeking out information on public companies, securities rules establish a detailed regime for ensuring that markets receive a regular flow of materially important information.¹⁷¹ With companies required to reveal deep troves of detailed, internal information, investors do not have to pay the costs of research or of negotiating access to corporate data. Because of this mechanism, investors freely receive a regular flow of financial statements, audited accounts, a narrative on management, corporate structure, risk factors and prospective plans.¹⁷²

Banks are different. If holding companies are publically traded, they must supply corporate data to the market in accordance with securities rules and be subject to the market discipline that this disclosure implies. However, banks also face the perennial risk that any sort of bad news might push depositors and short-term creditors to withdraw their funds, triggering bank runs, panic and contagion. This danger means that regulators often hold back key bank data from the public domain. Particularly when information develops out of bank supervisory assessments like stress tests, its dissemination might trigger the very crisis that regulators are working to avert. While this approach is gradually changing – with more information being made available by regulators (e.g. some stress test results) – public policy has traditionally dictated that fuller data about the inner health of banks be kept deliberately veiled.¹⁷³

This secrecy further heightens information costs and dampen the incentives of institutions to exercise active governance. Where acquiring knowledge on the workings of banks is expensive – as it almost certainly will be – investors will wish to have assurance of a payoff that is greater than what they invest. Further, investors will also need to spend money on executing intervention strategies, raising the threshold at which they might action their intelligence. Arguably, asset managers – as common agents – will have limited appetite to deal with such costs. Where fund managers wish to keep costs down – as often seems key to their business model – investing in resource intensive analysis may seem unfeasible.

¹⁷¹ John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 720–35 (1984); Merritt B. Fox et al., *Law, Share Price Accuracy and Economic Performance: The New Evidence*, 102 MICH. L. REV. 331, 339–41 (2003); Zohar Goshen & Gideon Parchomovsky, *On Insider Trading, Markets, and “Negative” Property Rights in Information*, 87 VA. L. REV. 1229 (2001); On market efficiency, Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970) (the seminal article arguing that market prices capture available information in prices).

¹⁷² Securities and Exchange Commission, Form-10-K, <https://www.sec.gov/answers/form10k.htm>.

¹⁷³ Mehran & Mollieux, *supra* note [150].

Particularly for larger, more complex banks, presenting a mix of decision, implementation as well as information costs, rational apathy presents an efficient course of action even for well-resourced investors.

2. Regulatory Costs and Rational Passivity

In addition to costs, the design of bank regulation creates incentives for shareholders to hold back from performing governance. This regulatory framework thus hardens the historically rational apathy of asset managers towards corporate governance.¹⁷⁴

To stave off the threat of a bank run and to prevent contagion from spreading into the economy, banks benefit from a number of support mechanisms: (i) deposit insurance; (ii) emergency credit from the Fed and potential implicit guarantees of assistance; and (iii) extensive oversight at the state and federal level. While such assistance can come at high taxpayer expense, its gains are evidenced by the assurance of a safer financial system.

Guarantees of state support, however, can distort the incentives of shareholders to be diligent in how they oversee a complex bank.¹⁷⁵

For a start, banks are overseen by a multiplicity public regulators, tasked with ensuring their safety and soundness. Also, banks are supported by deposit insurance, access to the Fed discount window and possible bailout assistance in the event that a bank is too big to fail. With the taxpayer investing heavily in bank surveillance, it makes little sense for shareholders to invest in further monitoring and intervention. With shareholders holding only incomplete reserves of information on these opaque and complex institutions, with decision-costs attached to action, it makes sense for shareholders to just rely on public oversight as a cheaper and possibly more effective approach to bank supervision.

In other words, the provision of express and implicit state support through deposit insurance, emergency credit as well as an extensive supervisory apparatus can further limit the interest of investors to govern diligently. Added to the high information, co-ordination and decision-costs, this leaves investors with little reason to pursue a policy of strict private oversight and diligence. With key corporate governance decisions subject to likely health-checks by regulators, the scope of investor action is further curtailed by the possibility of regulatory sanction. Ideas about

¹⁷⁴ Gilson & Gordon, *supra* note [116].

¹⁷⁵ MICHAEL BARR ET AL., FINANCIAL REGULATION: LAW AND POLICY (2016), 239-250; Diamond & Dyvbig, *supra* note [54].

mergers, re-making corporate structure (e.g. through sell-offs of bank units) or suggestions for future business (e.g. engaging in commodities trading) will be subject to scrutiny and sign-off by bank regulators seeking to maintain safety and soundness.¹⁷⁶ And so, even if investors are willing to intervene, they face the chance that their actions might attract the attention of public regulators and be stopped or limited.

Rational shareholder apathy is likely to be particularly pronounced at the largest banks given their deep information deficits, co-ordination problems and decision costs. As evidenced by their regular stress-tests, the largest banks should also get a high intensity of supervision by state and federal regulators in normal times, making it easy for shareholders to free-ride on public regulators for their own oversight.

Accounts of shareholder activism in banking remain limited. But emerging evidence appears to support this argument. In the one study to have considered all documented instances of shareholder action at banks between 1994 and 2010, a few key findings are worth noting. Importantly, bank holding companies do experience activism and intervention by shareholders – 334 banks experienced actions during the sample period. But not all banks were targeted equally. Rather, activists focused their attention on smaller banks, with high agency costs, suffering from low firm value, a lighter geographical footprint and with growth potential. Activists generally sought to engage management and to suggest strategic changes (altering business lines, improvements in operational efficiency etc.) as well as to encourage banks to declare dividends.¹⁷⁷

Anecdotally, instances of shareholder activism at the largest banks have tended to be much less frequent. And a cohort of specialist activist hedge funds, such as Trian Fund Management (that targeted State Street and Bank of New York Mellon) or Greenlight (that targeted Citizens Financial and CIT Corp) have taken the initiative.¹⁷⁸ This paucity of action

¹⁷⁶ Board of Governors of the Federal Reserve System. Concentration Limits on Large Financial Companies, 12 CFR Part 251 (Nov. 14, 2014) (this rule limits banks to merge that might create a single bank whose liabilities would be 10% or more of all U.S. liabilities). On activity restrictions, see, Omarova, *supra* note [40]; On living wills requiring sharper focus on simplifying corporate structure, see discussion *supra* Part [IIIA].

¹⁷⁷ Raluca A. Roman, *Shareholder Activism in Banking*, The Federal Reserve Bank of Kansas City Research Working Paper RWP 15-09 (August 2015); The research on shareholder activism is extensive. See, for example, Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1730 (2008) (showing the value-generative impact of hedge fund activists). On activist filings under the Williams Act, Lucian A. Bebchuk et al., *Pre-Disclosure Accumulations by Activist Investors: Evidence and Policy*, 39 J. CORP. L. 1 (2013) (noting that a substantial majority of the 13D filings were not made by hedge fund activist investors).

¹⁷⁸ Nathann Stovall, *Shareholder Activism Building in the Banking Industry*, Banking Exchange SNL Financial, Oct. 23, 2015; Tom Braithwaite, *U.S. Banks Can't Ignore Shareholder Activism*, FIN. TIMES, Oct. 29, 2012. In the case of State Street, for example, Trian tried to effect a change in management as well as to agitate for lower executive compensation and cost savings. For further discussion, see *infra* Part [III(B)].

should not be surprising, given the costs and complexities of staging interventions at the largest banks. It is also telling that they have been led by hedge funds, actors with their own money on the line, rather than asset managers looking after the wealth of their savers.

B. Common Agents as Bad for Banking

Scholars have pointed to bad corporate governance as a key cause driving the Crisis.¹⁷⁹ Theory explains why shareholders and managers at banks can both possess incentives to militate for short-term, risky gains. Because a small group of asset managers now hold large equity blocks at all the major banks, theory would suggest that they will be especially vulnerable to the play of these problem motivations.

Theory suggests that bank shareholders are primed to seek out risk. As residual claimholders and the bearers of default risk, shareholders gain by encouraging a bank to take on risk. They win when it performs profitably. If risks materialize, shareholders are wiped out in any event. Particularly as a firm edges towards a collapse, these distortions can become sharper as shareholders and managers go for broke to seek out a big win.¹⁸⁰ Incentives to push for risk become more powerful where shareholder winnings can be maximized through cheap leverage. Because banks can borrow cheaper relative to other firms, shareholders are well placed to push for greater risk-taking at the expense of a bank's creditors.¹⁸¹ For shareholders at the largest banks these motivations will be even more rationally compelling. The chance that shareholders are wiped out will be reduced by the promise of extra-sturdy public support: (i) the Fed will step in to provide emergency liquidity; (ii) the FDIC will guarantee a bank's short-term deposit liabilities; and (iii) regulators may very well offer a bailout to make sure that a really large bank does inflict serious economic damage by failing in a disorderly fashion. Because of these protections available – and the easy access to debt on better terms than other borrowers – bank shareholders should reasonably underprice the

¹⁷⁹ Douglas W. Diamond & Raghuram G. Rajan, *The Credit Crisis: Conjectures About Causes and Remedies*, NBER Working Paper No. w14739, 5-6 (2009); Schwarcz, *supra* note [145].

¹⁸⁰ See for example, Richard Squire, *Shareholder Opportunism in a World of Risky Debt*, 123 HARV. L. REV. 1151, 1182–93; See also discussion in Omarova, *supra* note [40].

¹⁸¹ Squire, *supra* note [180].

cost of their risk-taking. They will be slower to discount the value of their investment relative to how they might behave at other types of firm.¹⁸²

At first sight, asset managers, invested across multiple firms, seem to be particularly susceptible to these bad incentives. The scope and scale of the gains on offer are vast. They are invested across many of the biggest U.S. financial firms that have system-wide access to cheap credit and the greatest likelihood of carrying the “too-big-to-fail” label.

Also, asset managers can push managers by dint their power and influence. As blockholders with an enormous reserve of available capital, these asset managers represent especially persuasive voices to take managers down risk-chasing pathways.¹⁸³ Viewed in this way, even though bank governance entails high expense, the pay-offs could be tantalizing. For shareholders like Vanguard and BlackRock, blockholders across 22 out of the 25 banks studied, the cost-benefit trade-off might be worth pursuing. Rather than seeking out changes at every single one of their banks, it may be possible to encourage changes across many or most banks by taking action at one or two large institutions. With the possibility of a more system-wide impact across multiple firms as well as the chance that management might pursue pre-emptive changes before blockholders come calling, risky activist governance may provide real bang for the buck.

This interpretation, however, does not fit the usual behavior or incentives of fund managers. Without their own money on the line, common agents have little motive to push for outsize risk-taking and gains beyond what might be minimally expected by fund-holders. Where mutual funds are passively managed and aim to keep their fees low relative to their peers, the drive to seek out risks at banks might be even more muted. Added to the historical bias against aggressive action, past practice would suggest that the incentive to go for broke fits poorly against the fact that common agents manage other people’s money – not their own.

But, rational passivity by asset managers can still constitute a source of riskiness in large banking institutions. Passive asset managers may fail to invest in properly overseeing a bank. If they miss signs of risky behavior by managers or not not punish it in a timely way, their passiveness can breed negative externalities.¹⁸⁴

Passivity by large common investors like Vanguard and Fidelity can be risky where their apathy leads them to unquestioningly follow more

¹⁸² Natasha Sarin and Lawrence H. Summers, *Have Banks Gotten Safer*, Brookings Working Paper (Sept. 2016) (arguing that the franchise value of financial institutions has decreased since the pre-Crisis years).

¹⁸³ On the powerful influence of blockholders, Edmans & Holderness, *supra* note [11] (also discussing the finance literature surrounding the question of block holder influence).

¹⁸⁴ Gretchen Morgensen, *A Bank Too Big to Jail*, N.Y. TIMES, July 2016.

aggressive, activist players seeking governance changes. As Professors Gilson and Gordon persuasively argue, activism in corporate life tends to follow the lead of activist hedge funds that seek a return on their (own) money by suggesting changes to a target's governance practices. This comes with the benefit that apathetic institutional investors can simply go along with these more engaged actors without having to privately expend efforts and capital.¹⁸⁵ In banking, hedge fund activists can purchase a small stake in a bank and use this share to agitate for change – with asset managers maybe motivated to simply go along with a vocal shareholder advocate. Trian Partners, for example – an activist – agitated to change the governance of State Street and Bank of New York Mellon, large U.S. banks that specialize in the safekeeping of financial assets. Trian purchased a 1.2% share in State Street in 2011 (rising to 3.3% before being sold off in 2013) and a 2.5% stake in BNY Mellon in 2014 (worth \$1.05 billion at the time of purchase).¹⁸⁶ In the case of State Street, Trian published a 40-page list of State's Streets alleged problems and pushed for management to cut operating costs and increase revenue. For example, one of Trian's proposals suggested that State Street spin off its asset management arm – State Street Global Advisors – to take advantage of the revenue gains. While this latter proposal fell by the wayside, State Street's share price did climb and Trian sold at a profit in 2013.¹⁸⁷

A lot of controversy surrounds the question of whether hedge fund activists are a benefit or burden to corporate governance.¹⁸⁸ It is not the aim of this Article to take any position on this issue. The point is simply that activist advances in banks can implicate concerns of financial risk and externalities even while their workings might suggest, short-term improvements to share prices. For example, cost-cutting measures might involve shedding internal supervisory and compliance staff, increasing the workload on those left behind – or hiring less qualified individuals to fill the same positions. Spin-offs and sales may ultimately be systemically costly if an acquirer becomes overly unwieldy or takes on too much credit to pay for the purchase. Indeed, Professor Roman's study on shareholder activism in banking pointed to its potential to introduce riskiness into the financial system by creating pressure on management to produce higher shareholder returns – at a cost to the financial system as a whole.¹⁸⁹

¹⁸⁵ Gilson & Gordon, *supra* note [116].

¹⁸⁶ David Benoit & Saabira Chaudhuri, *Peltz's Trian Plants its Flag in BNY Mellon*, WALL ST. J., Jun. 30, 2014.

¹⁸⁷ Benoit & Chaudhuri, *supra* note [186].

¹⁸⁸ Margaret Collins, *Peltz's Trian Sold State Street Shares in Third Quarter*, BLOOMBERG, Nov. 14, 2013.

¹⁸⁹ Roman, *supra* note [177] (interestingly, Roman notes that the increased riskiness was not pronounced during a crisis – but rather ex ante in normal times).

Passivity by asset managers, then, may fail to catch instances of potentially damaging activism. Even though strategic passivity might follow the normal pattern of behavior for an institutional investor on Main Street, it can come with costs on Wall Street. Where the interests of an activist may be focused on a single firm for a determined horizon of time, that of Vanguard, Fidelity or BlackRock is broader and extends across the system of banks as a whole. While an activist agenda may be beneficial at one bank, its pursuit may result in an increase of risk at others, placing the longer-term value of funds invested by common agents at risk of erosion.

C. Common Agents as Beneficial for Banking

Common agents might, however, constitute a benefit for bank regulation. Their passivity, in particular, offers a counter-point to the conventional view that sees bank shareholders as risk-chasing and a danger to financial stability.

As discussed in Part II, asset managers have generally behaved as passive investors in corporate governance. Because they manage money for others, earn flatter compensation through management fees (rather than a cut of the profits) and try to keep their fees low for customers, the business case for activism can be hard to make. As I suggest here, bank governance, especially, can harden this apathy. The price tag for acquiring information and insight is high; and the availability of the public safety net can further dissuade shareholders from adopting a diligent position on governance. Given that asset managers are invested at the biggest and most systemic of U.S. banks, both these factors are likely to be persuasive.

But this historic trend towards apathy should also mean that, by themselves, asset managers should not fall prey to the worst inclinations of shareholders to use the banks' various privileges for risk-taking. While passivity has its problems (as outlined above), it can also work to insulate asset managers from bad shareholder behavior. Asset managers do not privately stand to take a cut of the gains across the various financial firms where they are invested. And whatever gains they do make will also accrue to competitor common agents, given that, as described in Part II, multiple block asset managers are now usual in bank capital structures.¹⁹⁰ The business structure of asset management, then, can result in shareholders less driven by risk-seeking self-interest, presenting regulators with a presumptively "safer" shareholder than what theory suggests. This

¹⁹⁰ Gilson & Gordon, *supra* note [116].

point of view is still speculative. Asset managers have only recently increased the intensity of their engagement with the banking sector, taking significantly greater block stakes from 2011 onwards. As shown in Part II, the average number of asset managers holding block stakes has increased by a factor of 110%, from an average of 1.45 in 2011 to 3.04 in 2016. How these shareholders behave, in fact, will become clearer over time. Seen from the standpoint of their business model, however – as well as historical record of passive governance – their presence might point to a more benign shareholder with the potential, if properly harnessed, to benefit regulation and financial stability.

In addition, to the extent that they may wish to engage in governance, common agents may be better placed, than other types of shareholder, to internalize its high costs. For instance, information costs are particularly high in banking given the opacity of loan assets and the challenges of valuing them. This can act as a barrier for ordinary shareholders looking to invest in working out the degree of default risk they hold. But for common agents, the costs of acquiring and analyzing information becomes more efficient to bear. As providers of capital, blockholders can negotiate with management to garner better insights about how a bank is run (e.g. by seeking out a board seat). Beyond this, their investment in privately acquiring knowledge about banks and banking can pay-off by being applicable to the many firms where asset managers are invested. A blockholder like Vanguard, for example, can apply insights gleaned about the industry to its portfolio of 22 large banks to understand individual firms in which it is invested. Efficiencies in curing informational deficits can help blockholders have stronger incentives to push informed governance ideas.

Indeed, by being able to cast an industry-wide eye across the financial market, blockholders provide a partial private fix to the concern that capital regulation is not sufficiently tailored to deal with system-wide risks. As Professor Acharya observes, capital reserves at individual banks may be too shallow to match the hit of a system-wide cascade of problems.¹⁹¹ Similarly, Professor Scott points to the problem of market-wide interconnection between firms as an amplifying catalyst for the spread of contagion across financial markets.¹⁹² As the Crisis made clear, financial firms showed themselves vulnerable to correlated risk-taking (e.g. all investing in real-estate referenced securities) that deepened the

¹⁹¹ Viral Acharya, *A Theory of Systemic Risk and Design of Prudential Bank Regulation*, Working Paper (2001).

¹⁹² Scott, *supra* note [4].

intensity of the hit as asset values fell simultaneously.¹⁹³ The current design of capital cushions takes some steps to deal with the problem of systemic risks, such as by imposing a special surcharge on the largest banks. This additional layer of capital can give the biggest firms an extra buffer to protect against sudden cascades of de-stabilizing risk and to also stop large risks from bleeding out from the bank into the financial system.

Asset managers like Vanguard and BlackRock can offer a, separate more “systemic” lens to better analyze the risks accumulating within financial markets. As blockholders across all the major banks, common agents possess information and clout. Most importantly, to the extent that systemic risks accumulate, their funds will lose value across multiple banks, such that there should be a strong business case for fund managers to invest in this research, information and good risk management.

IV. EXTENSIONS AND IMPLICATIONS

This Article makes following two contributions and arguments. First, it shows that the 25 largest and most important U.S. banks comprise a greater number of blockholders in their capital structure. Since 2011, in the period following the implementation of the Dodd-Frank Act, some of these top banks have gone from having zero block holders on their balance sheets to seeing multiple such shareholders take on sizable equity positions. In addition, a small group of asset managers have come to dominate as common agents in banking. Bank blockholders today comprise a cohort of asset management firms with block stakes at multiple large banks in the financial system. By become blockholders at the largest and most systemic U.S. banks, these asset managers – representing the savings of fund holders – have assumed the residual default risk of much of the financial system. Secondly, this Article examines the implication of this state of affairs for how asset managers might manage this default risk through corporate governance. As argued in Part III, the picture is mixed, with asset managers – as common agents – bringing both risks as well as benefits for bank regulation and governance. Below, in its third contribution, I briefly outline a proposal to try to better harness the strengths of asset managers as bank shareholders to motivate a more robust bank supervisory system. This outline represents a first step in a longer

¹⁹³ Indeed, this problem of correlated risk-taking in finance is discussed in detail by Vanguard in Vanguard, *Dynamic correlations: The Implications for Portfolio Construction*, Vanguard (April 2012), <http://www.vanguard.com/pdf/s130.pdf>; Marko Kolanovic, *Rise of Cross-Asset Correlations*, JP Morgan (May 16, 2011), <https://www.cboe.com/institutional/jpmcrossassetcorrelations.pdf>.

project to analyze the implications of how risk in the financial system is allocated and who bears it. The end goal is anchored in concerns of political economy to determine whether those contracting to bear the risks of the financial system possess the institutional resilience to do so.

A. A Duty to Supervise

Asset managers have considerable reason to exercise oversight of the financial system. They control funds that take on potentially large and also complex risks by owning block equity stakes at large and systemically significant banks. Banks are not ordinary companies. Their core design implicates risk: short-term liabilities (liabilities) constitute a basis for funding longer-term assets (loans). If banks run into problems, a rush by depositors to retrieve their cash can result in banks having to liquidate loans and sell off their assets in panicked, fire-sale conditions. Because depositors may fail to distinguish between banks, a crisis at one can spiral into a wider systemic collapse.¹⁹⁴ Such market-wide peril can have a particularly disastrous effect for asset managers that are invested widely in the financial system.¹⁹⁵ As seen in the aftermath of the 2008 Crisis, financial failure may prompt savers to see their fund portfolios lose value as well as to cash out they have saved with asset management firms.

From this standpoint, asset managers should be strongly motivated to perform oversight of the banking system. Those that save with them ought to also support the exercise of such scrutiny.

Indeed, regulators too possess real reasons to see asset managers perform more diligent oversight and governance in financial markets. As argued earlier, asset managers, as bank shareholders, present a much more palatable proposition than theory's hypothetical bank shareholder. Because of their historic passivity – they do not have their own money directly on the line – asset managers, in particular, may be much less motivated to chase risks at the expense of financial stability. Perhaps most importantly, asset managers are invested system-wide, with the likes of BlackRock and Vanguard possessing block equity investments in 22 out of the 25 big banks. This means that investments in information and analysis by asset managers should be well-spent. Further, because of their investment at multiple firms, asset managers should possess a systemic perspective when analyzing risk and exercising oversight. This can help reassure regulators.

¹⁹⁴ Diamond & Dwybig, *supra* note [54]; Ricks, *supra* note [4].

¹⁹⁵ Ricks, *supra* note [4], 113-122.

Rather than simply aligning themselves to short-term, risk-seeking bank managers at a single firm, asset managers may exercise a more systemic lens to dissuade a bank from taking risks (e.g. correlated exposures) that might imperil other firms within the financial system.

With asset managers embedded within the equity of the financial system, it seems timely to explore whether regulation will benefit from requiring asset managers to have an affirmative duty of diligent oversight. In other words, ought regulators to require those asset managers holding a block (or sizable) stake at a bank to take on a more explicitly pro-active role in monitoring the bank? Such a duty would require an asset manager to show that it has taken steps to more carefully monitor bank risk-taking, its system-wide impact and the steps and suggestions an asset manager has forwarded to improve governance outcomes at the bank.

A requirement that asset managers pay express attention to bank riskiness may, perhaps, be seen as falling foul of their corresponding fiduciary duty to fund-holders and to deliver returns. Higher transaction costs to perform governance, combined with reduced profits from a more cautious banking system might perhaps be argued as constituting a breach by an asset manager of her duty to fund holders.¹⁹⁶

But the requirement that asset managers do more to monitor banks should not face a serious challenge on this count. For one, an obligation on the part of asset managers to monitor banks does not require that shareholders stamp out all risk-taking (and thus all opportunities for a bank to make a profit) but, rather to scrutinize risk-taking more diligently for its impact on the bank's solvency and that of the financial system. Indeed, an asset manager's disapproval may fail to change a bank's policy if other shareholders fail to go along or if they disagree with its assessment of riskiness. As noted in Part III, firms may reasonably differ about what a safe, well functioning financial institution looks like and how it should operate as a matter of governance. In addition, scholars have long remarked that the content of a fund manager's fiduciary standard is notoriously fuzzy, giving rise to considerable uncertainty regarding how it should be interpreted.¹⁹⁷ This interpretative untidiness might permit room to allow regulation to create a stronger mandate on asset managers to scrutinize banks. As scholars have recognized, the peculiar nature of bank capital structure has impacted how the law interprets (and should interpret) traditional duties to which corporate law actors like directors are subject.¹⁹⁸

¹⁹⁶ See e.g. SEC v Capital Gains Research Bureau, 375 US 180 (1963), at 194-5

¹⁹⁷ See e.g. Arthur B. Laby, *The Fiduciary Structure of Investment Management Regulation*, in JOHN D. MORLEY & WILLIAM BIRDTHISTLE (EDS), RESEARCH HANDBOOK ON MUTUAL FUNDS (2017).

¹⁹⁸ Jonathan R. Macey & Maureen O'Hara, *The Corporate Governance of Banks*, Federal Reserve Bank of New York Policy Paper, 91, 92-93 (2003) (exhorting bank directors to be more circumspect and mindful of solvency risks); Patricia McCoy, *A Political Economy of the Business*

Particularly given that scrutiny by asset managers should protect fund interests from being diminished by bank recklessness, introducing a duty for asset managers to monitor should be legally sound to challenge.

A number of scholars have offered solutions to enhance corporate governance at financial institutions. Professor Schwarcz, for example, has advocated for bank managers to observe a duty to the “public interest” in the performance of their duties.¹⁹⁹ Professor Omarova suggests mandating bank boards to include a representative of the state to advocate on behalf of the public.²⁰⁰ Policy ideas such as these reflect the on-going uneasiness of observers that: (i) corporate governance and financial regulation are intrinsically linked; and (ii) that regulatory reform has not done enough to shore up this transmission channel for financial risk-taking.²⁰¹

This Article’s proposal also recognizes the connection between bank governance and financial stability. It is, however, shaped and motivated by the real-world emergence of asset managers as key shareholders taking on their books (or rather those of their funds) potentially enormous default risk. This proposal is grounded in the argument that asset managers should be safer bank shareholders, bringing a systemic lens to oversight as well as a deeper capacity to absorb and efficiently use research investments.

A proposal such as this, however, comes with drawbacks. First off, it runs counter to the business model and governance practices of asset managers. Traditionally passive, reluctant to charge high fees, and unlikely to see competitive benefit from active governance, mandating that asset managers supervise banks presents a serious practical challenge. For example, if asset managers must invest in information and action, they will presumably pass some or all of these costs on to customers. If savers must pay more to access long-term wealth management products, fewer might do so, depriving them of an important economic resource.

A mandate on asset managers to exercise engaged governance can thus backfire. At a time when banks need ready access to equity capital, governance costs may discourage asset managers from investing their fund capital into the bank equity. On the one hand, this might seem like a desirable outcome to the extent that reducing investment by asset managers in banking might lessen the default risk falling on fund holders. On the other, however, it might also give rise to undesirable outcomes. If

Judgment Rule in Banking: Implications for Corporate Law, 47 CASE W. L. REV. 1, 8-20 (1996) (noting the early judicial history on requiring directors to show deference to the special nature of banking and risk taking); Omarova, *supra* note [40], 1037.

¹⁹⁹ Schwarcz, *supra* note [145]; Min, *supra* note [145].

²⁰⁰ Omarova, *supra* note [40].

²⁰¹ See also, Hockett, *supra* note [40] (noting the limits of corporate law concepts in financial regulation).

asset managers pull back from the banking system, other capital providers may take their place. This might include funds that risk their own money, take bigger risks and that become susceptible to the perverse incentives that usually afflict bank shareholders. Where bank shareholders end up being more risk-seeking, their influence on the financial system may still place public savings at risk if the market falters or taxpayers are forced to provide a bailout to a failing system.

Secondly, there is no guarantee that asset managers will exercise good governance. Where suggestions are poorly thought out, asset managers may propagate bad ideas and compound risks within the system as a whole. For instance, they might offer similar proposals for different banks. This may be problematic as large banks do differ from one another and one-size-fits all solutions may cause more harm than good. For example, J.P. Morgan, Bank of America, Citigroup and Well Fargo are far bigger by asset size than other banks on the Fed's list. J.P. Morgan tops this list with more than \$2 trillion in assets, with Wells Fargo and Bank of America coming in next with around \$1.7 trillion in assets each. Arguably, decisions taken with respect to these banking giants may have a different effect on the financial system than, say, a similar proposal at a smaller, but still significant bank, like PNC Bank (asset size, approx., \$350 billion). A suggestion by an asset manager for banks to diversify and expand lending to, say, the energy sector can extract different costs depending on the bank. Lending will bring gains. However, it will also require that banks raise capital to meet the charge on (potentially) high risk loans. Banks can have differing costs of capital, depending on their capital structure. And if the loans default, the impact of this loss on the financial system will also vary. A hit to the likes of J.P Morgan will cause heavy stress on the financial system. However, a bigger bank will also be able to access the fullest array of state resources for assistance. Even without relying on state support, the biggest banks may perhaps be better able to withstand periodic hits, by dint of diversification, a deeper capital base (e.g. because of a higher G-SIFI capital surcharge) and access to international credit markets. In sum, asset managers may underestimate or misunderstand the fuller impact of their decision-making, a foreseeable outcome given the information asymmetries and complexities that are inherent to modern banking.

Thirdly, policy initiatives to lower the governance costs on asset managers are likely to be practically unworkable. To make it easier and cheaper for asset managers to comply with the duty, policymakers might try to help them defray these costs. For example, regulators might consider giving asset managers better access to information about bank performance. Richer information should yield more accurate assessments about bank risk and the degree of default exposure that fund holders are

assuming. Because of the public interest in ensuring that the wealth of savers is safe, taking measures to lower the compliance costs for asset managers may seem like a prudent idea. But interventions along this line of reasoning are riddled with problems. Asset managers might be nudged towards activism through the offer of cheaper information (for example). However, by getting special regulatory assistance, asset managers enjoy unfair advantages relative to other types of shareholder. By giving privileges to asset managers over other investors, regulators are putting their thumb on the scale in favoring one type of investment vehicle over another. Special access to information and assistance can also lead to the exact result regulators wish to avoid. With information, asset managers might consider banks too risky or too complex. They might sell their stake instead of investing in corporate governance actions. Such exits will send a powerfully negative signal to the market, potentially setting off panic about a bank's health. Conversely, cheap access to important information about critical institutions might prompt fund managers to over-invest in banking stocks, even if these present serious risks.

Finally, encouraging asset managers to exercise governance is likely to create serious concerns from the perspective of antitrust policy. Already, scholars have voiced deep misgivings about the broad block ownership by asset managers of public companies, arguing that it leads to collusive, anti-competitive conduct. They posit that, with the same set of asset managers holding stakes at competitor firms, U.S. public companies are more likely to engage in, or at least tolerate, anti-competitive behavior. In the airline industry as well as in banking, they point to a record of higher prices and reduced choice for consumers. This account remains contentious. However, its resonance will be amplified by financial regulatory policies seeking to encourage asset managers to use their block shareholder power to push governance outcomes at rival bank firms.²⁰² This Article's concern lies squarely in the field of financial regulation and motivated by the objective of harnessing the strengths of asset managers to build market solvency and protect the interests of fund holders. However, it is clear that policymakers will inevitably face regulatory choices that stand in tension and that require authorities to carefully scrutinize the conduct of private actors in public markets.

Importantly, creating a duty for asset managers to privately scrutinize the banks they invest in does not absolve public regulators from strenuously supervising markets or dealing with policy questions (e.g. resolving tension between financial regulation v. antitrust). Its goal is to highlight the key place of asset managers on the front line of financial risk

²⁰² See sources cited *supra* notes [29]

management in markets. With extensive broad block investment across the major U.S. banks, asset managers can offer a “systemic” lens to bolster, rather than replace or undermine, existing public oversight. Within this taxonomy, public regulators remain responsible for maintaining the safety and soundness of banking markets – as well as the conduct of major asset manager as common agents within it.

B. Questions for Future Research

This Article constitutes the first step in a longer project examining questions about how regulation allocates default risk in financial markets and whether those who hold it possess the institutional resilience to do so.

This work begins by identifying which actors are emerging as the key absorbers of default risk in post-Crisis financial markets. Following the Dodd-Frank Act, regulation is clear in requiring the largest U.S. banks to deepen their capital base and to ensure that it is more fully funded by issuing common equity. Whether because of this policy focus or due to some other reason (e.g. increasing inflows of capital to mutual funds), bank capital bases now include multiple asset managers as block holders. In examining the question of who holds this risk, then, this Article shows that it is being assumed by the largest asset managers, and ultimately those savers that entrust them with looking after their long-term wealth. In this work, I examined how effectively asset managers might behave as block shareholders to deploy their governance power to manage bank solvency.

But this inquiry gives rise to deeper institutional questions about the capacity of asset managers (and the funds they control) to bear the default risk for swaths of the financial system. Put simply, what might happen to BlackRock or Vanguard – and their funds – if the financial system were to see a widespread run on the biggest U.S. banks? If regulators decided that one or more major U.S. banks should be wind-down and for bank equity to be wiped out in order to pay off creditors, what kind of losses might savers suffer? How might an asset manager respond to prevent a sudden run on their funds in response to an imminent banking crisis – and will such steps be effective to staunch the bleeding within its own firm and also the financial system?

These questions constitute the subject of further research and scholarship. Its scope is not restricted to examining just the equity holdings of the biggest and most systemic U.S. banks. It extends more broadly to

also analyze those securities whose payouts rank low on the priority ladder, explicitly designed to be consumed by a wind-down procedure.²⁰³

Ultimately, this line of research aims to probe the limits of financial regulation and political economy. Regulation might set the rules by which banks are designed to be wind down, placing the risk of their failure on a certain cohort of actors. However, how those laws are implemented – if, indeed they are implemented at all, implicates issues of policy and political will. While Banco Popular might have been allowed to fail, with equity holders left to absorb the cost, other examples are less encouraging. In Italy, for example, a series near-bank collapses in 2017, impacting three of the country’s large banks, required the state to inject emergency liquidity as a way to avoid triggering a mandatory wind-down. One major reason explaining why Italian authorizes decided not to follow the law, instead favoring a short-term bank bailout, lay in the identity of those holding the risk of securities designed to absorb the losses. In Italy, these securities were held by ordinary, mom-and-pop, retail investors, deemed too economically vulnerable to take on bank losses.²⁰⁴

This example serves to highlight the significance of understanding more precisely and concretely the identity of those who ultimately support the default risk of large banks. While law seeks to build firewalls between too-big-to-fail firms and the real economy, whether these buffers hold up ultimately depends on who carries the burden. Understanding this interaction between financial regulation and politics can better reveal whether the laws on the books are really for purpose in practice.

V. CONCLUSION

This Article reveals a tension in financial markets regulation: as policy emphasizes shareholder equity as necessary to bank safety, the suppliers of this equity comprise a small cohort of asset managers, investing the savings of homes and businesses. With Main Street wealth exposed to the risks of large-scale financial failure, this Article explores the implications for bank corporate governance. It surveys how policy

²⁰³ For example, in the U.S., designated large banks must have enhanced “Total Loss Absorbency Capacity” or TLAC consisting of Tier 1 equity as well as certain other eligible debt securities that are subordinated to short-term debt. This TLAC, in theory, deepens the buffer that banks possess to withstanding a run. Federal Reserve Board of Governors, Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations, 12 CFR 252 Regulations YY; Docket No. R-1523.

²⁰⁴ See sources cited *infra* note [1].

might harness the strengths of asset managers to be good stewards of their fund capital in financial regulation. In so doing, I set the stage for exploring the fuller implications of capital regulation to more accurately determine how default risk is allocated in financial markets and who is charged with bearing it. In presenting this problem for policy, this Article lays out a pathway for future research designed to interrogate whether the laws on the books are really fit to be implemented in practice.

VI. APPENDIX

Table A – Ownership Data on Large Blockholders from 2016 Proxy Statements

Bank Holding Company	% BlackRock	% Vanguard	% Fidelity (FMR LLC)	% State Street	% T. Rowe Price
Ally Financial					
Amex					
Bank of America	5.7	5.7			
Bank of NY Mellon	5.90	5.49			5.20
BB&T	5.4	5.73			
Capital One	6.12	5.68	5.23		
Citigroup	6.8	5.5			
Citizens Financial	6.14	6.65			
Comerica	5.7	8.3	7.70		
Discover	7.6	5.88			
Fifth Third Bank	5.8	5.9		5.5	
Goldman Sachs	6.37	5.22		5.23	
Huntingdon Bank	5.80	8.96	7.18	6.22	
JP Morgan	6.4	5.9			
KeyCorp	8.87	8.7		5.93	
M&T Group	6.20	7.94	6.14		
Morgan Stanley	5.30			7.10	6.70
Northern Trust	5.50	5.40			6.30
PNC Financial	5.10	6.00			
Regions Bank	7.10	8.44	8.95	5.70	
State Street	5.10	5.40			7.10
Sun Trust	11.07	5.62	5.99	4.99	
US Bancorp	6.55	5.30	5.09		
Wells Fargo	5.60	5.40			
Zions Bank	5.10	8.22		6.10	

Table B – Ownership Data on Large Blockholders from 2011 Proxy Statements

Bank Holding Company	% BlackRock	% Vanguard	% Fidelity (FMR LLC)	% State Street	% T. Rowe Price
Ally Financial (N/A Ally became a public company in 2014)					
Amex					
Bank of America No Blockholders					
Bank of NY Mellon	5.16				
BB&T No Blockholders					
Capital One	6.25				
Citigroup No Blockholders					
Citizens Financial N/A –fully-owned subsidiary of the U.K.’s Royal Bank of Scotland					
Comerica	5.58		9.166		
Discover	6.32	5.12	9.87		

Fifth Third Bank No Blockholders					
Goldman Sachs					
Huntingdon Bank	6.41		13.998		
JP Morgan	5.52				
KeyCorp	7.4		5.4		
M&T Group					
Morgan Stanley	5.44			10.59	
Northern Trust					
PNC Financial No Blockholders					
Regions Bank			8.666		
State Street					
Sun Trust	5.29		6.63		
US Bancorp	5.14				
Wells Fargo					
Zions Bank			9.41		