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Kristin Johnson
Seton Hall University School of Law

Steven A. Ramirez
Loyola University Chicago School of Law

Cary Martin Shelby
DePaul University College of Law

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Diversifying to Mitigate Risk: Can Dodd–Frank Section 342 Help Stabilize the Financial Sector?

Kristin Johnson*
Steven A. Ramirez**
Cary Martin Shelby***

Table of Contents

I. Introduction 1796
II. The Empirical Foundation for Enhanced Diversity in Finance 1806
III. The Increasing "Publicness" of Financial Institutions 1819
  A. Federal Regulation of "Publicness" 1820
  B. Financial Innovation and Complexity......................1825
  C. Public Subsidies for Private Institutions 1830
IV. Systemic Risk and Risk Management...........................1833
  A. Risk Regulation in Financial Markets....................1833
V. Regulating Diversity...1840
  A. Mechanics of Section 342...1842
  B. Diversity Standards for Regulated Entities 1845
    1. Joint Standards 1846
    2. Voluntariness...1848

* Kristin Johnson, Professor of Law, Director of the Regulation, Governance and Risk Management Program, Seton Hall University School of Law.

** Steven A. Ramirez, Professor of Law, Associate Dean of Research & Faculty Development, Director, Business Law Center, Loyola University Chicago School of Law.

*** Cary Martin Shelby, Associate Professor, DePaul University College of Law.

VI. Safety & Soundness and Diversifying to Mitigate Risk 1851
A. The Federal Banking Regulators 1852
B. The SEC and the Securities Industry 1860
VII. Conclusion....1867

I. Introduction

As the global financial crisis of 2007–2009 continues to reverberate across the global economy,[1] financial regulation remains at the forefront of public discourse.[2] The underlying causes of the crisis still generate controversy.[3] By any measure, however, the financial institutions at the center of the financial crisis are special for many reasons.[4] Increasingly, these businesses

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1. *See, e.g.*, ADAIR TURNER, BETWEEN DEBT AND THE DEVIL 213 (2015) ("Seven years after the 2007–2008 financial crisis the world's major economies are still suffering its consequences."); Maximilian Walsh, *Financial Crisis Still Not Over Seven Years After Lehman Brothers*, AUSTRALIAN FIN. REV. (June 3, 2015), http://www.afr.com/opinion/columnists/financial-crisis-still-not-over-seven-years-after-lehman-brothers-20150603-ghfmkn#ixzz3pijkm4di (last visited Dec. 11, 2016) ("The Great Recession—the one we were not supposed to have—is now seven years old and, despite the best efforts of an army of professional economists, recovery remains tentative.") (on file with the Washington and Lee Law Review).

2. *See* Donna Borak, *Donald Trump, Jeb Hensarling Meet on Dodd-Frank Alternative*, WALL ST. J. (June 7, 2016), http://www.wsj.com/articles/donald-trump-jeb-hensarling-meet-on-dodd-frank-alternative-1465335535 (last visited Dec. 13, 2016) (highlighting the debate over Jeb Hensarling's plan to repeal 2010 Dodd–Frank law) (on file with the Washington and Lee Law Review).

3. *Compare* Lynn A. Stout, *Derivatives and the Legal Origin of the 2008 Credit Crisis*, 1 HARV. BUS. L. REV. 1, 27–28 (2011) (assigning primary cause of the financial crisis to derivatives deregulation), *with* Steven A. Ramirez, *The Virtues of Private Securities Litigation: An Historic and Macroeconomic Perspective*, 45 LOYOLA U. CHI. L.J. 669, 720 (2014) ("[A]t bottom, massive securities fraud defines the Great Financial Crisis of 2008 and led to an historic financial collapse."). The financial crisis of 2008 was a highly complex event and its causes are similarly complex. *See generally* STEVEN A. RAMIREZ, LAWLESS CAPITALISM: THE SUBPRIME CRISIS AND THE CASE FOR AN ECONOMIC RULE OF LAW (2013) [hereinafter RAMIREZ, LAWLESS CAPITALISM] (comprehensively identifying all legal and regulatory flaws contributing to the financial crisis). Sound risk management in the financial sector could apply to mitigate many if not all of these putative causes.

4. *See* E. Gerald Corrigan, *Are Banks Special?*, *in* THE LAW OF FINANCIAL INSTITUTIONS 57 (5th ed. 2013) (debating whether banks are "special" enough to

demonstrate a uniquely "public" character.[5] While historically some financial firms may have organized as partnerships[6] and the consequences of their decision-making perceived as "private,"[7] in the contemporary period, the great financial crisis reveals that decisions made in the inner-sanctum of these businesses may adversely affect domestic and international economies and the public at large.[8] Many such institutions engineered and invested in high risk financial instruments that ultimately generated large losses.[9] These losses triggered a run on the shadow banking sector[10] and later crippled the conventional banking sector and spelled calamity for the global economy.[11] Ultimately, the entire

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receive unique regulatory treatment).

5. In conventional corporations jargon, describing a business as "public" intimates that the company has registered securities with the Securities & Exchange Commission (SEC) for sale to the public. This Article invokes a more creative understanding of "publicness." *See infra* Part III.A (exploring the concept that institutions perceived as "systemically important financial institutions" or "too big to fail" may have incentives to internalize the benefits of excessive risk taking and export the negative consequences; these negative externalities may spill over to the broader domestic and international communities).

6. *See, e.g.*, LISA ENDLICH, GOLDMAN SACHS: THE CULTURE OF SUCCESS 15 (2009) (describing the history of the ownership structure of Goldman Sachs Group, Inc.).

7. *Id.*

8. *See infra* Part III.B (explaining private transactions that are exempt from federal regulations).

9. *See infra* Part III.B (describing how exotic derivatives allowed banks to re-sell debt absent federal oversight).

10. *See* ZOLTAN POZSAR ET AL., FED. RESERVE BANK OF N.Y., STAFF REP. NO. 458, SHADOW BANKING, at 1 (2010), https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr458.pdf (explaining how "the shadow banking system provide[s] sources of funding for credit by converting opaque, risky, long-term assets into money-like, short-term liabilities"). There is no universally agreed upon definition for shadow banking. *See* Steven L. Schwarcz, *Regulating Shadow Banking: Inaugural Address for the Inaugural Symposium of the Review of Banking & Financial Law*, 31 REV. BANKING & FIN. L. 619, 623, 626 (noting that "we lack a concrete definition of shadow banking" while also emphasizing that "a high level of institutional demand for (especially) short-term debt instruments" was a critical factor in the growth of what is now "known as the 'shadow banking system'" (citation omitted)).

11. *See* TYLER ATKINSON ET AL., DALLASFED, HOW BAD WAS IT? THE COSTS AND CONSEQUENCES OF THE 2007–09 FINANCIAL CRISIS 2 (July 2013), https://dallasfed.org/assets/documents/research/staff/staff1301.pdf (estimating total cost of crisis in United States alone at up to fourteen trillion dollars).

financial sector benefited from the federal bailout of the industry.[12] Remarkably, the homogenous demographic make-up of the senior management teams[13] changed very little after the financial crisis.[14]

For almost a century, a complex web of federal legislation was purportedly designed to protect the general public from the negative consequences of financial institutions' business decisions.[15] Banking laws for example, include specific capital and reserve requirements, governance mandates, and detailed licensing standards, to reduce systemic risk.[16] Federal securities laws include an intricate mandatory disclosure framework for public companies to protect investors and to promote efficient and transparent markets.[17]

Commentators frequently posited that the culture within financial firms encouraged flouting rules.[18] Many claimed that the insular settings reinforced biases and encouraged excessive

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12. For example, the Federal Reserve System lent trillions to 407 financial institutions during the darkest days of the crisis. *See* Phil Kuntz & Bob Ivry, *Fed's Once-Secret Data Compiled by Bloomberg Released to Public*, BLOOMBERG (Dec. 23, 2011, 12:01 AM), http://www.bloomberg.com/news/articles/2011-12-23/fed-s-once-secret-data-compiled-by-bloomberg-released-to-public (last visited Dec. 15, 2016) (reporting that total federal lending reached sixteen trillion dollars) (on file with the Washington and Lee Law Review).

13. U.S. GOV'T ACCOUNTABILITY OFFICE, TRENDS AND PRACTICES IN THE FINANCIAL SERVICES INDUSTRY AND AGENCIES AFTER THE RECENT FINANCIAL CRISIS 10, 15 (2013), http://www.gao.gov/assets/660/653814.pdf.

14. *See generally* EMMA JORDAN COLEMAN, CTR. FOR AM. PROGRESS, A FAIR DEAL FOR TAXPAYER INVESTMENTS 1 (Sep. 2009), https://cdn.americanprogress.org/wpcontent/uploads/issues/2009/09/pdf/public_directors.pdf (finding that one year after the financial crisis "92 percent of the management and directors of the top 17 recipients of TARP funds are still in office").

15. *See id.* at 4 (introducing the Troubled Asset Relief Program intended to rescue failing financial systems).

16. *See id.* at 8 (attempting to create a central federal bank to increase market liquidity by cutting rates).

17. *See id.* at 5 (restoring trust and public confidence is critical to maintain future market stability).

18. *See* FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT xix (2011) (indicating that the primary government inquiry into the causes of the financial crisis found that "stunning instances of governance breakdowns and irresponsibility" within financial firms drove all aspects of the crisis as a key cause).

risk-taking across financial markets.[19] Unprecedented compensation[20] and brazen behavior, buttressed by perceptions that decisions made on behalf of the firm would have limited consequences for individual senior managers, created an environment devoid of accountability.[21] The fact that these institutions sported little cultural diversity did not escape notice.[22]

A veil of "privateness" obscured many of the complex financial products and transactions that facilitated the crisis.[23] Regulators

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19. *See, e.g.*, *The Causes and Current State of the Financial Crisis: Before the Fin. Crisis Inquiry Comm'n* (2010) (statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation) (claiming unregulated, low interest rates encouraged consumer borrowing and excessive leverage); Viral V. Acharya & Matthew Richardson, *Causes of the Financial Crisis*, 21 CRITICAL REV. 195, 195 (2009)

> [Financial institutions] had temporarily placed assets—such as securitized mortgages—in off-balance-sheet entities, so that they did not have to hold significant capital buffers against them . . . [and that] the capital regulations . . . allowed banks to reduce the amount of capital they held against assets that remained on their balance sheets—if those assets took the form of AAA-rated tranches of securitized mortgages. Thus, by repackaging mortgages into mortgage-backed securities, whether held on or off their balance sheets, banks reduced the amount of capital required against their loans, increasing their ability to make loans many-fold. The principal effect of this regulatory arbitrage, however, was to concentrate the risk of mortgage defaults in the banks and render them insolvent when the housing bubble popped.

Id.; Arthur E. Wilmarth, Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem*, 89 OR. L. REV. 951, 954 (2011) (describing the assumption that "too big to fail" institutions will receive public financial support during economic crises).

20. *See* Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 247 (2010) (discussing how executives' insulation from losses leads to a disregard for long-term risk-taking effects).

21. *See generally* MARY K. RAMIREZ & STEVEN A. RAMIREZ, THE CASE FOR THE CORPORATE DEATH PENALTY: RESTORING LAW AND ORDER ON WALL STREET 1–28 (2017); Kristin N. Johnson, *Governing Financial Markets: Regulating Conflicts*, 88 WASH. L. REV. 185, 227 (2013) [hereinafter *Governing Financial Markets*] (discussing how federal government bailouts coupled with unregulated controls encourage directors to make risky management decisions).

22. The United States Government Accountability Office found that as of 2011 senior managers in the financial sector were eighty-nine percent whites and seventy-one percent males. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 13, at 10, 15. These numbers changed little from the numbers prevailing before the Great Financial Crisis at the senior manager level. *Id.*

23. *See* FIN. CRISIS INQUIRY COMM'N, *supra* note 18, at xx (indicating that

and lawmakers deemed large financial institutions to be "too sophisticated to regulate" and acted to exempt them from regulation.[24] Notwithstanding the litany of existing federal regulation, expanding notions of "privateness"—and concomitant deregulation—dominated the pre-crisis period.[25] Even financial institutions that were publicly-traded companies successfully evaded conventional disclosure mechanisms for financial instruments that were too complex to depict.[26] When the crisis erupted in the fall of 2007, both public and private institutions clamored to gain direct or indirect access to federal bailout funds.[27] The crisis revealed flaws in federal regulation of financial institutions' risk management oversight.[28]

For decades, scholars have posited that introducing greater diversity among decision-making authorities, such as the board of

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major financial institutions were able to hide high leverage ratios from public investors).

24. *See id.* at xviii (explaining that regulating major financial firms was thought unnecessary because self-preservation supposedly shielded them from fatal risk-taking).

25. *See id.* at xx ("Key components of the market . . . were hidden from view . . . We had a 21st-century financial system with 19th-century safeguards.").

26. *See id.* at 8 (depicting the increasingly complex financial instruments that "became too hard to 'untangle'" within the securities market).

27. *See id.* at 256 ("[A] handful of banks were bailing out their money market funds and commercial paper programs in the fall of 2007 . . . .").

28. As used in this Article, the term risk management means the mechanisms by which the business enterprise manages all risks facing the enterprise. Thus, it transcends the mere use of financial instruments to hedge portfolio positions and is closely associated with enterprise-wide risk management (ERM). *See* Betty Simkins & Steven A. Ramirez, *Enterprise-Wide Risk Management and Corporate Governance*, 39 LOYOLA U. CHI. L.J. 571, 586 (2008) (defining enterprise-wide risk management as "enhanced financial management through enhanced identification and management of all the risks facing the corporation" and showing that "[t]his systematic and comprehensive approach to risk management has been empirically tested and the results show that ERM delivers upon its theoretical promises"). Congress and the financial regulators enhanced ERM regulatory requirements in the aftermath of the financial crisis. *See* Kristin Johnson, *Addressing Gaps in the Dodd-Frank Act: Directors' Risk Management Oversight Obligations*, 45 U. MICH. J.L. REFORM 55, 63 (2011) [hereinafter *Addressing Gaps in the Dodd-Frank Act*] (stating that risk management "involves organizational processes that generally include risk identifying, measuring, and mitigating procedures").

directors and senior executives, could lead to superior outcomes.[29] As Christine Lagarde, former Minister of Economic Affairs, Finance and Employment of France and Managing Director of the International Monetary Fund (IMF) eloquently argued, if "Lehman Brothers had been 'Lehman Sisters,' today's economic crisis clearly would look quite different."[30] Referencing a study examining a sample of banks around the world that demonstrates that less than twenty percent of bank board members are women and only three percent of bank Chief Executive Officers (CEOs) are women,[31] Lagarde described the need for greater gender diversity on financial institution management teams.[32] Former Citigroup Chief Financial Officer (CFO) Sallie Krawcheck shared similar reflections, positing that in her experience "diverse teams . . . tend to make more effective decisions . . . [because] they bring in more perspectives."[33]

While examples of egotism and bravado abound,[34] critics posit that these anecdotes only demonstrate well-established moral or

29. *See infra* Part II (finding that maintaining homogenous groups will draw unoriginal ideas and provide a stagnant information base).

30. Christine Lagarde, *Women, Power and the Challenge of the Financial Crisis*, N.Y. TIMES (May 10, 2010), http://www.nytimes.com/2010/05/11/opinion/11iht-edlagarde.html?dbk (last visited Dec. 15, 2016) (on file with the Washington and Lee Law Review).

31. Christine Lagarde, Managing Dir., Int'l Monetary Fund, Speech at the Institute for New Economic Thinking: Financing and Society (May 6, 2015).

32. *See id.* at 1 ("[E]stablishing a culture where ethical behavior is rewarded and where lapses in ethical integrity are not tolerated. More women would also help. Several studies have shown female leadership is more inclusive.").

33. Sallie Krawcheck, *How "Lehman Siblings" Might Have Stemmed the Financial Crisis*, PBS NEWSHOUR (Aug. 6, 2014, 12:54 PM), http://www.pbs.org/fnewshour/making-sense/how-lehman-siblings-might-have-stemmed-the-financial-crisis/ (last visited Dec. 13, 2016) (on file with the Washington and Lee Law Review).

34. Consider, for example, the email messages of Fabrice Tourre, a creator of the infamous Abacus transaction. *See* Chris V. Nicholson, *Fabrice Tourre: Fabulous or Fatally Flawed?*, N.Y. TIMES (Apr. 19, 2010, 1:49 PM), http://dealbook.nytimes.com/2010/04/19/fabrice-tourre-fabulous-or-fatally-flawed/ (last visited Dec. 13, 2016) ("The whole building is about to collapse anytime now . . . . Only potential survivor, the fabulous Fab[rice Tourre] . . . standing in the middle of all these complex, highly leveraged, exotic trades he created without necessarily understanding all of the implications of those monstrosities!!!") (on file with the Washington and Lee Law Review); *see also* Donald C. Langevoort, *Chasing the Greased Pig Down Wall Street: A Gatekeeper's Guide to the*

ethical deficiencies in the cowboy culture of Wall Street. Scholars long ago began finding benefits from well-managed diversity but some argue more evidence is needed to make the case in favor of greater diversity.[35] The challenges that all businesses face with respect to decision-making and managing risk introduce a set of questions that merits exploration. When one considers the risk management failures[36] that large and systemically important

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Psychology, Culture, and Ethics of Financial Risk Taking, 96 CORNELL L. REV. 1209, 1226 (2011) ("This emotional and social account meshes fairly well with what we observe inside highly competitive financial firms. There is a strong emotional emphasis on team building and bonding—fraternity-like excesses included.");

> Recall the claim that the bankers' culture is of-the-moment and bows to the innate legitimacy of the market mechanism, seeking an unquestioning synchronicity with it . . . this view probably cannot be construed as a belief in the unerring accuracy of the market at any given moment so much as a Hayekian view of the necessary freedom of persons and firms to be tested in the crucible of the marketplace.

Id. at 1237.

35. *See, e.g.*, Steven A. Ramirez, *Diversity and the Boardroom*, 6 STAN. J.L. BUS. FIN. 85, 85–87 (2000) (collecting sources regarding the advantages of a diverse workforce). More recently, scholars recognize that while well-managed diversity may lead to superior board performance, the empirical data on the mere presence of diverse board members is mixed. *See* Deborah L. Rhode & Amanda K. Packel, *Diversity on Corporate Boards: How Much Difference Does Difference Make?*, 39 DEL. J. CORP. L. 377, 393 (2014) ("Although empirical research has drawn much-needed attention to the underrepresentation of women and minorities on corporate boards, it has not convincingly established that board diversity leads to improved financial performance."); Lissa Lamkin Broome & Kimberly D. Krawiec, *Signaling Through Board Diversity: Is Anyone Listening?*, 77 U. CIN. L. REV. 431, 432–33 (2008) ("Recent quantitative studies primarily test for a relationship between board diversity and various measures of corporate performance. . . . [S]tudies find evidence that . . . board diversity positively affects firm performance. Other studies, however, find no support for this theory."); Lisa M. Fairfax, *Clogs in the Pipeline: The Mixed Data on Women Directors and Continued Barriers to Their Advancement*, 65 MD. L. REV. 579, 593 (2006) (summarizing the empirical data addressing the impact of diversity contingent upon the number of women in the boardroom). We do not address this debate regarding general board diversity in this Article, instead focusing on the potential benefits of diversifying the financial sector from top to bottom, that is, from the boardroom down to rank-and-file workers.

36. *See* Kristin N. Johnson & Steven A. Ramirez, *New Guiding Principles: Macroprudential Solutions to Risk Management Oversight and Systemic Risk Concerns*, 11 U. ST. THOMAS L.J. 386, 426 (2014) (recognizing continued reliance on corporate governance-oriented reforms will ultimately increase market disruptions and recounting risk management failures before and during the

financial institutions endured during the financial crisis,[37] these questions become all the more poignant.

To address shortcomings in federal regulatory oversight and the risk management failures, Congress adopted the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd–Frank Act).[38] The Dodd–Frank Act introduces many transformative risk oversight policies.[39] Among the reforms, Congress created an obligation for financial regulators to assess the gender and racial diversity policies of financial institutions.[40] This Article focuses on Section 342(b)(2)(c) of the Dodd–Frank Act which directs each federal financial regulatory agency to assess the diversity policies and practices of entities regulated by the agency.[41] The Article concludes that the Dodd–Frank Act appropriately focused on diversity as one mechanism to achieve superior risk management in the financial sector, and that regulators should more aggressively implement Congress's statutory directive.

Part II of this Article focuses on the growing empirical evidence in the psychology, finance, and management literature that demonstrates that cognitive biases influence group decision-making and that well-managed cultural and gender diversity can breakdown these cognitive biases. In terms of finance, this translates into superior risk management as diverse groups hold more heterogeneous perspectives on risk, ethics, and market decisions in a way that can lead to superior outcomes on these issues.

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financial crisis).

37. *See Addressing Gaps in the Dodd-Frank Act, supra* note 28, at 71–72 (describing risk management failures of various firms and subsequent solvency crises during the period 2007–2011).

38. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010), https://www.sec.gov/about/laws/wallstreetreform-cpa.pdf.

39. *See id.* § 111(a) (enhancing supervision and regulation through establishment of the Financial Stability Oversight Council).

40. *See id.* § 342(a)(1)(B) (mandating the formation of the Office of Minority and Women Inclusion to develop standards for racial, ethnic, and gender diversity).

41. *See id.* § 342(b)(2) (requiring the agency administrator and Office of Minority and Women Inclusion Director to design implementation procedures and remedies resulting from violation).

Part III posits that increasingly blurred lines challenge our understanding of private businesses. Increasing federal regulation illustrates a trend toward presumptions that systemically important financial institutions, in particular, are public in nature, even if private by design. The macroeconomic significance of large financial institutions justifies more stringent macroprudential regulation across the financial sector.

Part IV offers a brief survey of the issues at the center of financial markets regulation: academics' understanding, practitioners' experience, and regulators' best efforts to identify, implement and enforce risk management policies intended to promote macroeconomic stability and macroprudential risk management. Sound risk management in the financial sector plays a key role in dealing with regulatory and legal challenges arising from the increased public stakes in banking and finance.

Part V of this Article examines the Congressional mandate for imposing an obligation for regulatory agencies to "assess" the diversity policies and practices of financial institutions regulated by the agency. Part VI contends that the transformative changes in financial markets coupled with risk management lessons from the recent crisis demand a more aggressive interpretation of financial market regulators' obligations to "assess" diversity at financial institutions. This Part of the Article posits that the regulators should use their traditional authority to stem unsafe and unsound banking practices (and similar prudential regulations) to encourage more diversity in the financial sector. Otherwise, the regulators risk undermining Congressional efforts to mitigate risk management challenges in financial markets and ensure macroeconomic stability and macroprudential regulation.[42]

Section 342, while not suggesting that the increasing diversity alone solves risk management oversight concerns, offers a partial response to known risk management weaknesses in senior management teams in the financial sector.[43] Congress correctly

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42. Enhanced risk management figured prominently in the Dodd–Frank Act. *See, e.g.*, Dodd–Frank Act §165(h)(3)(A) (requiring certain systemically important financial institutions to form independent "enterprise-wide risk management committees").

43. Long before the financial crisis scholars debated the business benefits of diversity:

identified a major shortcoming in the corporate governance of the financial sector. According to the joint standards promulgated by the federal regulatory agencies,[44] Section 342's mandate will only require a voluntary self-assessment of diversity-oriented risk management initiatives.[45] This Article demonstrates that federal regulatory agencies' interpretation of Section 342 frustrates Congress's intentions regarding diversity as a risk management tool. At best, agency efforts stymie or undermine the potential for the statutory mandate. At worst, the federal regulatory agencies' interpretation leaves Section 342 completely impotent creating greater potential for macroeconomic destabilization.[46] As such, an

> The point here goes back to my metaphor of the firm as a nexus of negotiations. The promotion of diversity may or may not hold a position of power within the firm. If I am right [about potential costs] its power rarely will be great. Simple demands of adherence because of the rightness of the cause are unlikely to provoke a cooperative response among those who disagree on (perhaps self-serving) principled grounds.

Donald C. Langevoort, *Overcoming Resistance to Diversity in the Executive Suite: Grease, Grit, and the Corporate Promotion Tournament*, 61 WASH. & LEE L. REV. 1615, 1642 (2004); *see also* Steven A. Ramirez, *Games CEOs Play and Interest Convergence Theory: Why Diversity Lags in America's Boardrooms and What to Do About It*, 61 WASH. & LEE L. REV. 1583, 1613 (2004) ("CEOs play the game of homosocial reproduction when they select directors . . . [b]ut, because board diversity can improve corporate governance, racial reformers may find many allies . . . in this arena.").

44. *See* Final Interagency Policy Statement Establishing Joint Standards for Assessing the Diversity Policies and Practices of Entities Regulated by the Agencies, 80 Fed. Reg. 33016 (June 10, 2015) [hereinafter Joint Guidelines] (discussing the contentious public commentary over the standards promulgated by the Office of Minority and Women Inclusion), http://www.gpo.gov/fdsys/pkg/FR-2015-06-10/pdf/2015-14126.pdf. The Article refers to this group of regulatory agencies as the "financial regulators." *Id.*

45. *See infra* Part V (providing a detailed explanation of the Joint Standards that apply to regulated entities).

46. Under a law and macroeconomics approach, the focus is on the relationship of law and regulation to macroeconomic performance. *See* Steven A. Ramirez, *The Law and Macroeconomics of the New Deal at 70*, 62 MD. L. REV. 515, 519 (2003) ("[L]aw can further economic output and other macroeconomic goals."). Macroprudential regulation considers the use of law and regulation to secure financial stability on a systemic basis and therefore looks beyond prudential risk regulation at just single financial institutions. *See* Kristin N. Johnson, *Macroprudential Regulation: A Sustainable Approach to Regulating Financial Markets*, 2013 U. ILL. L. REV. 881, 903–04 (2013) [hereinafter *Macroprudential Regulation*] (explaining systemic risk and the consequences that flow from the

opportunity to both diversify and stabilize the financial system has so far been wasted.[47] The simple remedy may be for federal financial regulators to execute their mandate, enforce the statute through the broadest possible regulatory powers, and consider cultural and gender diversity in the financial sector as a key mechanism to enhance risk management and legal compliance in the financial sector.

II. The Empirical Foundation for Enhanced Diversity in Finance

Scholars from a range of disciplines have long studied group decision-making challenges arising in part from culturally homogenous groups.[48] Among other limitations, groupthink,[49]

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interconnectedness of financial institutions). Major financial institutions operate under pervasive public supervision because their activities can lead to severe financial instability with all of the negative economic consequences inherent in such crises, and because the largest financial firms hold a poorly defined claim on massive public resources for their survival. *See* Cary Martin Shelby, *Are Hedge Funds Still Private? Exploring Publicness in the Face of Incoherency*, 69 SMU L. REV. 405, 449–50 (2016) [hereinafter Shelby, *Are Hedge Funds Still Private?*] (arguing in favor of enhanced regulation of hedge funds given the enhanced publicness of their activities).

47. The Joint Guidelines state that they "create no new legal obligations," and that the financial regulators "will not use their examination or supervisory processes in connection with the [Joint Guidelines]." Joint Guidelines, *supra* note 44, at 33. As such, they truly constitute "lip service" and defy the plain meaning of the statute, which requires an "assessment" of each regulated entity's diversity policies. *See* 15 U.S.C. § 5452(b)(2) (2012) (imposing director-created standards to increase agency's participation with minority-owned and women-owned businesses).

48. *See, e.g.*, IRVING R. JANIS, VICTIMS OF GROUPTHINK 78 (1978) (discussing problems associated with "groupthink").

49. Groupthink is "a mode of thinking that people engage in when they are deeply involved in a cohesive in-group, when the members' striving for unanimity overrides their motivation to realistically appraise alternative courses of actions." Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233, 1238 (2003) (quoting JANIS, *supra* note 48, at 78).

herd behavior,[50] and affinity bias[51] challenge group decision-making. Similarly, humans naturally fall prey to confirmation bias,[52] overconfidence,[53] and structural bias.[54] These flaws in cognition lead to an inclination to look for and adopt information that confirms intuitive beliefs and a tendency toward selective information gathering and deference to superiors such as executives or managers based on perceptions that such team members are better informed.[55] Evidence suggests that these tendencies can be mitigated through enhanced cultural diversity.[56]

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50. Financial crises frequently arise from herd behavior—a dynamic whereby decision-makers rely on the decisions of others rather than just their own information. *See* Abhijit V. Banerjee, *A Simple Model of Herd Behavior*, 107 Q.J. ECON. 797, 800 (1992) (finding that herd behavior may explain asset price volatility). Commentators note that the financial crisis was an instance of "herd-effects" and self-reinforcing judgments derived solely from the judgments of others. TURNER, *supra* note 1, at 40.

51. Affinity bias results from the inability of humans to make decisions free of bias relating to those we share affinity with through friendship, social status, or other socially significant relationships. *See* Antony Page, *Unconscious Bias and the Limits of Director Independence*, 2009 U. ILL. L. REV. 237, 248–49 (showing that affinity bias may infect board deliberations).

52. *See id.* at 265 (searching for information supporting current beliefs but ignoring contrary information).

53. *See id.* at 280 (pointing to "naïve realists" who falsely believe their decisions are always objective in nature).

54. *See* O'Connor, *supra* note 49, at 1265 (noting that impartial leaders may also cause structural faults as they state their own views but discourage dissent).

55. *See id.* at 1238 (striving for unanimity prevents individuals from considering alternative courses of action).

56. *See, e.g.*, CREDIT SUISSE, GENDER DIVERSITY AND CORPORATE PERFORMANCE 6 (2012) (finding that "companies with at least one woman on the board would have outperformed in terms of share price performance" and that "[a]lmost all of the outperformance . . . was delivered post-2008, since the macro environment deteriorated and volatility increased"); David A. Carter et al., *Corporate Governance, Board Diversity, and Firm Value*, 38 FIN. REV. 33, 51 (2003) ("After controlling for size, industry, and other corporate governance measures, we find statistically significant positive relationships between the presence of women or minorities on the board and firm value . . . ."); Toyah Miller & María del Carmen Triana, *Demographic Diversity in the Boardroom: Mediators of the Board Diversity–Firm Performance Relationship*, 46 J. MGMT. STUD. 755, 774–75 (2009) (finding that between 2002 and 2005 Fortune 500 firms with gender and racial diversity on boards performed better than non-diverse firms and finding that the link can be explained through innovation and firm reputation). The focus of this Article is on cultural diversity within the financial firms, from top to bottom. Thus, we do not address here the efficacy of board

In fact, discrete cultural differences exist in the U.S. with respect to many important issues, including risk perceptions and ethical sensitivities.[57]

These lessons also hold true in the world of finance. For example, evidence supports the conclusion that greater participation by women senior executives may militate against solvency concerns for banking institutions.[58] There is strong empirical support for the conclusion that women executives exhibit less over-confidence and hold different perceptions of risk relative to men.[59] A sample of 6,729 banks during the financial crisis

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diversity alone beyond the financial sector. *Compare* Joan M. Heminway, *Women in the Crowd of Corporate Directors: Following, Walking Alone, and Meaningfully Contributing*, 21 WM. & MARY J. WOMEN & L. 59, 79 (2014) (arguing that increasing the number of women on boards could enhance diversity because "[r]esearch offers evidence that women may bring game-changing perspectives and proficiencies to the boardroom"), *with* Lisa M. Fairfax, *Board Diversity Revisited: New Rationale, Same Old Story?*, 89 N.C. L. REV. 855, 855 (2011) (challenging generally the reliance on business rationales to justify increased board diversity and "insists that diversity advocates must pay greater attention to the role of social and moral justifications in the effort to diversify the corporate boardroom").

57. For example, as early as 2007, scholars recognized that white-male risk perceptions were skewed. *See* Dan M. Kahan et al., *Culture and Identity-Protective Cognition: Explaining the White-Male Effect in Risk Perception*, 4 J. EMPIRICAL LEGAL STUD. 465, 465–66 (2007) ("Numerous studies show that risk perceptions are skewed across gender and race: women worry more than men, and minorities more than whites, about myriad dangers—from environmental pollution to hand guns, from blood transfusions to red meat."). Legal scholars suggested this white-male risk perception should be balanced in the name of reducing bias, unfairness, and poor governance simultaneously. *See* Regina F. Burch, *Worldview Diversity in the Boardroom: A Law and Social Equity Rationale,* 42 LOYOLA U. CHI. L.J. 585, 594 (2011) ("This Article proposes that greater worldview diversity on corporate boards may lead to better governance and mitigate bias and unfairness in corporate decision making.").

58. *See* Ajay Palvia et al., *Are Female CEOs and Chairwomen More Conservative and Risk Averse? Evidence from the Banking Industry During the Financial Crisis*, 131 J. BUS. ETHICS 577, 592 (2015) (concluding test results offer a positive correlation between female CEOs and lower risk of bank failure); Kristin Johnson, *Banking on Diversity: Does Gender Diversity Improve Financial Firms' Risk Oversight*, 69 SMU L. REV. (forthcoming 2017) (manuscript at 29–33) (citing sources and studies exploring the significance of gender in the context of risk-management oversight) (on file with the Washington & Lee Law Review).

59. *See, e.g.*, Jiekun Huang & Darren J. Kisgen, *Gender and Corporate Finance: Are Male Executives Overconfident Relative to Female Executives?*, 108 J. FIN. ECON. 822, 822 (2013) (finding that "[m]ale executives undertake more acquisitions and issue debt more often than female executives" and that female

revealed that banks with women CEOs or board chairmen held more conservative levels of capital after controlling for, among other attributes, the risks in the bank's asset portfolio, the size of the bank, and the economic conditions in the bank's state.[60] When women serve as the heads of banks, the banks tend to hold greater amounts of capital, which enables the bank to guard against insolvency concerns.[61] The "observed differences in capital ratios are economically significant and indicate that female-led banks hold about 5-6% more capital than male-led banks."[62] These more conservative levels of capital translated into a lower risk of bank failure.[63] As such, a rigorous analysis of cultural diversity "complement[s] . . . evaluating the safety and soundness of banks."[64] Though some may argue that this finding means women are superior risk managers,[65] we argue only that heterogeneous

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executives give earnings guidance with wider ranges); Mara Faccio et al., *CEO Gender, Corporate Risk-Taking, and the Efficiency of Capital Allocation*, SOC. SCI. RES. NETWORK (Feb. 12, 2016), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2021136 (last visited Dec. 13, 2016) ("[F]irms run by female CEOs tend to make [less risky] financing and investment choices . . . than . . . firms run by male CEOs . . . CEO transitions indicates that . . . firm [risk-taking] tends to . . . around the transition from a male to a female CEO (or vice-versa).") (on file with the Washington and Lee Law Review).

60. *See* Palvia et al., *supra* note 58, at 592 ("From a public policy perspective, the documented benefits of female leadership for bank stability may be of interest to regulators when setting future policies for promoting gender equality and the advancement of women in business.").

61. *Id.* at 582 (acknowledging that the sample size is small because women are so underrepresented at the top of financial sector).

62. *Id.* at 592.

63. *See id.* (reporting that banks led by female CEOs hold higher levels of equity capital due to their control over the bank's asset risk).

64. *Id.*

65. *See, e.g.*, JULIA DAWSON ET. AL., THE CS GENDER 3000: WOMEN IN SENIOR MANAGEMENT 3 (2014) ("[G]reater diversity in boards and management are empirically associated with higher returns on equity, higher price/book valuations and superior stock price performance."). Interpreting empirical data on cultural diversity and bank risk management is, of course, complicated. First, as always, there are limits on empirical research. As with virtually all empirical studies, variables may be omitted; the sample size may be too small; the direction of causation may not be clear; and virtually all methodologies have noteworthy shortcomings. *Id.* Further, for businesses, too much risk aversion may be undesirable. This Article simply highlights the best evidence on the issue of whether risk management can be optimized through enhanced cultural diversity in the financial sector.

risk management is superior to culturally homogenous risk management.

Similarly, another study of subprime lending at financial firms found that firms with more female representation engaged in less subprime lending.[66] Utilizing a database of subprime lenders from the U.S. Department of Housing and Urban Development, Professors Muller-Kahle and Lewellyn matched subprime lenders with non-subprime lenders by size and industry and found that board configuration in the two sets of firms differed in statistically significant ways.[67] Specifically, the non-subprime lenders had boards with more gender diversity, longer board tenure, and were less busy.[68] The study design mitigates issues relating to causation by splitting the firms into two subsets (subprime lenders and non-subprime lenders) and focusing on the explanatory variables the year prior to any firm entering the subprime mortgage market.[69] The study finds "that board gender diversity adds value to a board."[70] Furthermore, "[t]he greater the percentage of women on the board, the less likely a firm was to specialize in subprime lending."[71] In short, the deterioration of mortgage lending standards underlying the subprime debacle may have been preventable had there been greater diversity on financial institution boards.[72]

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66. *See generally* Maureen I. Muller-Kahle & Krista B. Lewellyn, *Did Board Configuration Matter? The Case of US Subprime Lenders*, 19 CORP. GOVERNANCE: AN INT'L REV. 405 (2011).

67. *Id.*

68. *Id.* at 412–13; *see also id.* at 409 (defining busyness as the number of outside board seats held by each outside director divided by the number of outside directors).

69.

> [R]everse causality is less plausible, given our research design. In our empirical tests, all of our independent variables are collected in the year preceding the firm identified on the subprime list. Thus, measures for our explanatory [variables] in the earlier period could not have resulted from being identified as a subprime specialist in the subsequent period.

Id. at 409

70. *Id.* at 414 ("For enhanced decision making processes, firms would be advised to strive to add diversity to boardrooms.").

71. *Id.* at 413.

72. *Id.* at 405. Another recent study involving European banks found that

Even beyond boards and senior managers, diversity pays dividends in terms of risk management in the financial sector. One study found that female loan officers are more risk averse and more inclined to restrict loans to unseasoned borrowers.[73] Another study found that female loan officers also experience lower default rates on loans they approve relative to male loan officers.[74] These studies suggest that financial firms would experience gains for diversifying all levels of operations, not just senior management teams.[75]

The above empirical studies also draw support from a rich body of empirical evidence that shows that diversity necessarily results in different approaches to risk. As early as 1988, researchers showed in experimental studies that women tend to be more conservative and risk averse than men.[76] These findings were confirmed by empirical studies that investigated household investment behavior and personal financial decisions.[77] In sum, according to a review of all experimental studies in the *Journal of*

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boards with more women had lower risks. *See generally* Ruth Mateos de Cabo et al., *Gender Diversity on European Banks' Boards of Directors*, 109 J. BUS. ETHICS 145 (2012).

73. *See* Andrea Bellucci et al., *Does Gender Matter in Bank-Firm Relationships? Evidence from Small Business Lending*, 34 J. BANKING & FIN. 2968, 2968–69 (2010) (examining the impact of gender on business lending practices).

74. *See* Thorsten Beck et al., *Gender and Banking: Are Women Better Loan Officers?*, 17 REV. FIN. 1279, 1317 (2013) (studying the performance differences between male and female loan officers).

75. *See id.* at 1282–83 ("These findings suggest that not only the institutional and governance structure of financial institutions matters, but also the gender of the people operating in a given bank structure."); *see also* Bellucci et al., *supra* note 73, at 2969 (suggesting that female loan officers are more risk averse than men in order to avoid defaults and losses for their institutions and maximize personal career advancement).

76. *See* Irwin P. Levin et al., *The Interaction of Experiential and Situational Factors and Gender in a Simulated Risky Decision-Making Task*, 122 J. PSYCHOLOGY 173, 180 (1988) (finding that women students were more risk averse than male students in an experimental setting).

77. *See, e.g.*, John Watson & Mark McNaughton, *Gender Differences in Risk Aversion and Expected Retirement Benefits*, 63 FIN. ANALYSTS J. 52, 60 (2007) ("Considerable psychological evidence suggests that women are generally more risk averse than men . . . and the results of this study indicate that this heightened risk aversion influences the superannuation/retirement investment choices women make.").

Economic Literature, "[a] large literature documents gender differences in risk taking; women are more risk averse than men."[78] This empirical reality does not necessarily suggest that women inherently manage risk better than males; in fact, at least one study suggests that the risk aversion of females may negatively impact earnings.[79] We may, however, conclude that heterogeneous risk assessments, including a diversity of perspectives offers greater informational elaboration.[80]

This empirical reality also applies to the approach of ethnic minorities to issues related to risk. A recent analysis of the extant empirical evidence on this point found that white males are the most aggressive demographic group in terms of investment behavior.[81] African-American and Hispanic households also display more risk aversion than white households in their investment choices in the wake of the Great Recession.[82] In

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78. Rachel Croson & Uri Gneezy, *Gender Differences in Preferences*, 47 J. ECON. LITERATURE 1, 7 (2009).

79. *See* Catherine C. Eckel & Philip J. Grossman, *Men, Women and Risk Aversion: Experimental Evidence*, *in* 1 HANDBOOK OF EXPERIMENTAL ECONOMICS RESULTS 1061, 1069 (Charles R.C. Plott & Vernon L. Smith eds., 2008) (detailing studies that show, generally, systematic differences between male and female reaction to risk(citing HAIM LEVY ET AL., GENDER DIFFERENCES IN RISK TAKING AND INVESTMENT BEHAVIOR: AN EXPERIMENTAL ANALYSIS (1999) (unpublished manuscript))).

80. Our theory is rooted in the work of psychologists that found group intelligence can exceed the intelligence of any single member, particularly when the group is diverse. *See* Anita Williams Woolley et al., *Evidence for a Collective Intelligence Factor in the Performance of Human Groups*, 330 SCI. 686, 688 (2010) ("[R]esults provide substantial evidence for the existence of [collective intelligence] in groups . . . ."). An alternative theory also supports our thesis that the financial regulators should take stronger steps to encourage more diversity in the financial sector. Specifically, some argue that males are over-confident and systemically underestimate risk. *See, e.g.*, Jeff Sommer, *How Men's Overconfidence Hurts Them as Investors*, N.Y. TIMES (Mar. 13, 2010), http://www.nytimes.com/2010/03/14/business/14mark.html?_r=0 (last visited Dec. 15, 2016) (examining differences in investment behavior between women and men) (on file with the Washington and Lee Law Review).

81. *See* James Farrell, *Demographic and Socioeconomic Factors of Investors*, *in* INVESTOR BEHAVIOR: THE PSYCHOLOGY OF FINANCIAL PLANNING AND INVESTING 117 (H. Kent Baker & Victor Ricciardi eds., 2014) (compiling and reviewing empirical studies focusing on the differences in investment behavior across race and gender groups).

82. *See* Su Hyun Shin & Sherman D. Hanna, *Decomposition Analyses of Racial/Ethnic Differences in High Return Investment Ownership after the Great*

addition to approaching risk differently, ethnic diversity also may help avoid and mitigate financial market bubbles.[83]

A recent study, published in the *Proceedings of the National Academy of Sciences*, by a team of six economists, business scholars, and other academics from around the world found that markets with diverse participants resist price bubbles.[84] The team constructed experimental financial markets in Southeast Asia and North America.[85] Market participants were randomly assigned to participate in diverse or culturally homogenous markets.[86] The culturally diverse markets fit true values fifty-eight percent better than the homogenous markets.[87] In addition, the homogenous market overpriced assets and trader errors were more correlated.[88] This all suggests that homogenous markets are more prone to bubbles than culturally diverse markets.

As the authors of the study conclude:

> Markets are central to modern society, and their failures can devastate people, communities, and nations. We find that price

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Recession, 26 J. FIN. COUNSELING & PLANNING 43, 57 (2015) (examining home ownership, risk tolerance, and education across varying demographic groups).

83. *See* Sheen S. Levine et al., *Ethnic Diversity Deflates Price Bubbles*, 111 PROC. NAT'L ACAD. SCI. 18524, 18524 (2014) ("Our results suggest that bubbles are affected by a property of the collectivity of market traders—ethnic homogeneity.").

84. *See id.* at 18527 ("[T]raders in diverse markets reliably price assets closer to true values. They are less likely to accept inflated offers and more likely to accept offers closer to true value, thereby thwarting bubbles.").

85. *See id.* at 18525 (explaining how the researchers selected the geographic sites of the experiments to purposely exploit non-overlapping ethnic diversity in those two locales and to generalize their findings beyond rich, developed nations). In North America, the diversity tested was whites, Latinos, and African-Americans. *Id.* In Southeast Asia, the researchers studied diversity in the form of Malays, Indians, and Chinese traders. *Id.*

86. *See id.* at 18525–26 (detailing how the experiment involved skilled traders with training in business or finance and outlining how—because the traders in the experiments received their earnings in cash at the end of the experiment—they faced incentives to trade effectively).

87. *See id.* at 18526 ("Across markets and locations, pricing accuracy is 58% higher in diverse markets."). Pricing accuracy was obtained by giving participants all information needed to price the stocks accurately, and the initial declarations of value formed the baseline for trading accuracy. *Id.* at 18525.

88. *See id.* at 18524 ("In homogenous markets, overpricing is higher and traders' errors are more correlated than in diverse markets.").

> bubbles are fueled by the ethnic homogeneity of traders. Homogeneity, we suggest, imbues people with false confidence in the judgment of coethnics, discouraging them from scrutinizing behavior. In contrast, traders in diverse markets reliably price assets closer to true values. They are less likely to accept inflated offers and more likely to accept offers that are closer to true value, thereby thwarting bubbles. This pattern is similar in Southeast Asia and North America, even if the two sites differ greatly in culture and ethnic composition, in what is implied by "ethnic diversity" and how it is operationalized.[89]

In short, this study demonstrates that if the bank regulators are concerned with the systemic risks of bubbles they should aggressively seek to diversify the financial sector with the full panoply of tools provided by Congress.[90] This would vindicate macroprudential regulation needs by securing less volatile financial markets.

Ethics and compliance concerns also counsel in favor of aggressive steps to diversify the financial sector.[91] Apparently the different approach of women to issues relating to risk also leads to more ethical behavior and legal compliance.[92] According to one recent study, female CEOs exercise more conservativism with respect to accounting issues.[93] Another study found that female

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89. *Id.* at 18527. The results are based upon 2,022 transactions by 180 traders in thirty different markets—fourteen diverse and sixteen homogenous. *Id.* The market with the lowest accuracy was the homogenous market in North America—i.e., the market with all white traders. *Id.*

90. *See infra* Part V (articulating the means by which the financial regulators can use the tools at their disposal to more aggressively diversify the financial sector).

91. *See* William A. Weeks et al., *The Effects of Gender and Career Stage on Ethical Judgment*, 20 J. BUS. ETHICS 301, 310–11 (1999) ("[I]t appears that an influx of more females into the work force might improve the ethical environment based on how ethical problems are perceived and resolved.").

92. *Id.* Social scientists theorize that women approach ethics differently based upon gender socialization. *See* Leslie Dawson, *Ethical Differences Between Men and Women in the Sales Profession*, 16 J. BUS. ETHICS 1143, 1143–44 (1997) ("This theory holds that general and nearly universal differences that characterize masculine and feminine personalities are formed in childhood and are incontrovertible; these in turn differentially shape the work-related interests, concerns, and values of the sexes.").

93. *See* Simon S.M. Ho et al., *CEO Gender, Ethical Leadership, and Accounting Conservatism*, 127 J. BUS. ETHICS 351, 366 (2015) ("Regardless of the measure of conservatism, we find consistent evidence that companies with female

board representation leads to fewer accounting restatements.[94] The authors suggest that this finding is consistent with the disruption of groupthink and superior group decision-making dynamics.[95] Similarly, at least with respect to Chinese firms, when there is more gender diversity on the board, there is less securities fraud.[96] Women are more likely to speak out against unethical behavior and blow the whistle on misconduct than males.[97] Finally, there is additional empirical evidence that African-Americans, Latinos, Asian-Americans, and whites have different ethical sensitivities.[98]

These differences in ethical sensibilities suggest that business would be well-advised to diversify in order to assure that its behavior conforms to the ethical expectations of all its key constituencies—labor pools, supply chains, capital sources,

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CEOs report earnings more conservatively.").

94. *See* Lawrence J. Abbott et al., *Female Board Presence and the Likelihood of Financial Restatement*, 26 ACCT. HORIZONS 607, 626 (2012) ("Using a matched-pair sample of restatement and control firms, we conducted conditional logistic regressions comparing the characteristics of restatement and control firms. Briefly, we find a significant reduction in the likelihood of financial restatement and the presence of at least one female board director."). As always, the authors acknowledge issues related to possible omitted variables and the direction of causation. *Id.* at 626–27.

95. *See id.* at 611–13, 627 ("We draw upon the groupthink and group dynamics perspectives to suggest that female board presence creates an atmosphere in which viewpoints that may disrupt group cohesion are communicated and considered, and the pace of decision-making is slowed.").

96. *See* Douglas Cumming et al., *Gender Diversity and Securities Fraud*, 58 ACAD. MGMT. J. 1572, 1573 (2015) ("Our evidence shows that gender diversity reduces the likelihood of being in our fraud sample and reduces the severity of the fraud.").

97. *See* Iris Vermeir & Patrick Van Kenhove, *Gender Differences in Double Standards*, 81 J. BUS. ETHICS 281, 290 (2008) ("[W]omen are systematically less tolerant towards unethical actions compared to men . . . ."); *see also* Joyce Rothschild & Terance D. Miethe, *Whistleblower Disclosures and Management Retaliation: The Battle to Control Information About Organization Corruption*, 26 WORK & OCCUPATIONS 107, 113 (1999) ("Internal whistle-blowers were far more likely to be women than men . . . .").

98. *See, e.g.*, Costas Hadjicharalambous & Lynn Walsh, *Ethnicity/Race and Gender Effects on Ethical Sensitivity in Four Sub-Cultures*, 15 J. LEG. ETHICAL & REG. ISSUES 119, 128 (2012) (offering an empirical analysis of ethical variations across different racial/ethnic and gender groups).

consumers, and communities.[99] This point benefits from empirical support that shows that firms with more diverse boards achieve higher corporate social responsibility ratings.[100] Diversity gives financial firms the key to unlocking the prodigious value of an enhanced reputation and ethicality by assuring that no important constituency finds the firm's conduct repellent and that the firm's conduct fully acclimates itself to the full spectrum of ethical sensitivity within its operating environment.[101] Therefore, the financial regulators should also impose more powerful diversification standards for the purpose of insuring greater compliance and higher ethical standards in the financial sector.

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99. *See* Maretno Harjoto et al., *Board Diversity and Corporate Social Responsibility*, 132 J. BUS. ETHICS 641, 642 (2015) ("Firms could suffer both monetary and reputational losses from failing to align management's interests with those of their stakeholders. Effective stakeholder management is a critical requirement for firm success.").

100.

> Given that group dynamics and decision making vary depending on the background of the individuals serving on corporate boards, a diverse group of directors brings a different knowledge base, sets of experiences, and perspectives on society to group decision making. As a result, diversity increases the board's ability to recognize the needs and interests of different groups of stakeholders as reflected on CSR performance.

Id.

101. *See* Stephen Bear et al., *The Impact of Board Diversity and Gender Composition on Corporate Social Responsibility and Firm Reputation*, 97 J. BUS. ETHICS 207, 207 (2010)

> Corporate reputation refers to "publics' cumulative judgment of firms over time." Research has demonstrated a broad range of benefits associated with a positive reputation. A good reputation enhances a firm's ability to attract job applicants. Reputation affects employee retention as employees who feel their company is well regarded by external groups have higher job satisfaction and a lower intention to leave their organizations. A positive reputation also enhances corporate branding, enabling a company to use its brand equity to launch new products and enter new markets. Reputation can positively affect financial performance, institutional investment, and share price. A study by Mercer Investment Consulting indicated that 46% of institutional investors consider environmental, social, and corporate governance when making investment decisions, and McKinsey reports that institutional investors will pay a premium (12–14%) for well-governed companies.

The true potential of ethnic and gender diversity to assure a more stable financial sector with superior risk management capabilities is just now beginning to emerge from the world of social science. For example, no proponent of well-managed diversity would advocate mere tokenism as a mechanism of unleashing the full benefits of well-managed cultural diversity.[102] Instead, diversity management requires that diverse experiences represent a critical mass in any group setting to allow a robust exchange of ideas and perspectives.[103] Thus, studies regarding the impact of a critical mass of diverse voices are just now beginning to show how diversity in the boardroom leads to greater innovation

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102. As one of us highlighted in a seminal article on diversity in business in 2000:

> Many corporations, most notably Texaco, have suffered dire consequences from an inability to manage diversity. These instances, however, do not detract from the central thesis of this article that businesses are using diversity as a competitive advantage in order to maximize profits, and that the legal system should accommodate, encourage and respond positively to this new paradigm of viewing diversity as a strength. Instead, these instances highlight the need for policies that assure that business organizations truly embrace diversity rather than pursue policies of tokenism or tacit exclusion. The point is that diversity must be properly managed.

Steven A. Ramirez, *Diversity and the Boardroom*, *supra* note 35, at 109–10. Indeed, the concept that diversity must be embraced through policies and the pursuit of best practices highlights the fundamental distinction between affirmative action (which focuses on bringing traditionally excluded groups into organizations and institutions) and diversity policies (which seek to further an organizations institutional mission through broadening cognitive perspectives and experiences). *Id.* at 109–24.

103. As Rachel Moran states:

> Tokenism is the enemy of diversity. For groups previously excluded from access to legal education, feelings of alienation and isolation not only retard academic achievement but also silence the very voices that are the building blocks of a diverse law school. A critical mass of these students is necessary to achieve a truly diverse student body that contributes to the robust exchange of ideas.

Rachel F. Moran, *Of Doubt and Diversity: The Future of Affirmative Action in Higher Education*, 67 OHIO ST. L.J. 201, 208 (2006) (quoting Rachel F. Moran et al., Statement of Faculty Policy Governing Admission to Boalt Hall and Report of the Admissions Policy Task Force 24 (1993)). *See also* Marleen A. O'Connor, *Women Executives in Gladiator Corporate Cultures: The Behavioral Dynamics of Gender, Ego, and Power*, 65 MD. L. REV. 465, 468 (2006) (suggesting that in the absence of a critical mass of diverse directors a single diverse member is likely to succumb to pressures to conform).

and firm performance—and such studies focusing on critical mass are limited by the fact that few boards include a critical mass of women much less ethnic minorities.[104] Many prior studies of the impact of diversity in the world of business or finance necessarily fail to deal with the confounding effects of tokenism.[105] Ethnic and racial diversity is so rare that virtually no empirical studies can assess the effect of a critical mass of senior managers on financial performance and risk management.[106]

Nevertheless, insofar as the Diversity Guidelines are concerned there can be little doubt that in light of the above-referenced empirical evidence the regulators should proceed more aggressively with respect to the issue of enhanced cultural diversity in the financial sector, and fully vindicate the Congressional intent underlying Section 342. More diverse financial institutions will curtail risk through the multi-dimensional perceptions of risk that a diverse workforce and senior management manifestly bring to the table.[107] Further, more diverse financial traders will lessen the propensity for financial traders in homogenous markets to generate asset bubbles[108]—

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104. *See* Jasmin Joecks et al., *Gender Diversity in the Boardroom and Firm Performance: What Exactly Constitutes a "Critical Mass?"*, 118 J. BUS. ETHICS 61, 70 (2013) ("[W]e find evidence for a U-shaped link between gender diversity on the board and firm performance . . . [a board] needs a critical mass of women . . . to realize the advantages a more diverse board may offer. We find this critical mass to be in the range of about 30% female representation . . . ."); *see also* Mariateresa Torchia et al., *Women Directors on Corporate Boards: From Tokenism to Critical Mass*, 102 J. BUS. ETHICS 299, 312 (2011) ("[Our] results show that the Boards' contribution to . . . innovation is higher in boards with 'at least three women': boards where women directors reach critical mass.").

105. *See* Corinne Post & Kris Byron, *Women on Boards and Firm Financial Performance: A Meta-Analysis*, 58 ACAD. MGMT. J. 1546, 1556 (2015) (reviewing 140 studies and finding that gender diversity on boards enhances financial performance and accounting earnings in nations that have strong investor protections and enjoy high gender parity but that "less than a handful" of studies measure diversity through the lens of "critical mass").

106. *See* Lissa Lamkin Broome et al., *Does Critical Mass Matter? Views from the Boardroom*, 34 SEATTLE U. L. REV. 1049, 1078 (2011) ("[V]ery few of our texts address the issue of a critical mass of minority (as opposed to female) directors. In part, this reflects the simple fact that it is hard to find a public company with three or more minority directors.").

107. *See* Abbott, *supra* note 94, at 627 (suggesting that increased firm diversity will inhibit or eliminate the risks of groupthink).

108. *See* Levine et al., *supra* note 83, at 18524 (explaining the correlation

which carry huge macroprudential risks for the entire financial sector. The financial crisis has been viewed as one of the greatest episodes of risk mismanagement in history.[109] Diversity can enhance sound risk management, which itself is a proven mechanism for superior financial performance,[110] as will be discussed in more detail in Part IV below.

III. The Increasing "Publicness" of Financial Institutions

The federal government today holds a compelling interest in managing the risks the financial sector poses to the general economy of the United States.[111] The financial crisis of 2007–2009 caused trillions in losses to the general economy and led to hundreds of billions in federal bailouts.[112]

This Part explains how the increasing "publicness" of financial institutions has created the need for creative and cost-effective solutions. Banking and financial regulation at the federal level historically responded to major macroeconomic disruptions, such as the Great Depression.[113] While financial institutions are generally subject to a complex web of federal regulation, these restrictions failed to protect the general public against the harmful innovations that precipitated the financial crisis and led to large macroeconomic losses.[114]

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between ethnic homogeneity and price bubbles).

109. *See* RAMIREZ, LAWLESS CAPITALISM, *supra* note 3, at xi–xviii ("The nation's largest financial institutions gorged on levels of risk—particularly in the subprime (even predatory) mortgage business—unparalleled in U.S. financial history.").

110. *See* Vincent Aebi et al., *Risk Management, Corporate Governance, and Bank Performance in the Financial Crisis*, 36 J. BANKING & FIN. 3213, 3224 (2012) (finding that banks with a more independent risk management function outperformed other banks during the financial crisis).

111. *See* RAMIREZ, LAWLESS CAPITALISM, *supra* note 3, at xviii ("[I]n a modern capitalist state, an economic rule of law is necessary to prevent the subversion of capitalism arising from excessive concentrations of wealth.").

112. *Id.* at xi–xviii.

113. *See* Ramirez, *supra* note 46, at 515–22 (providing broad overview and assessment of New Deal financial regulation).

114. *See* RAMIREZ, LAWLESS CAPITALISM, *supra* note 3, at 75 ("A steady drumbeat of deregulation, nonregulation, and misregulation paced the entire

This Part begins with an overview of the federal securities laws that attempt to regulate the "publicness" of financial institutions and continues by highlighting the inherent limitations in applying these regulations to the "private" decisions of these entities. For instance, the proliferation of innovative financial products, which were intertwined with toxic subprime mortgages, created pervasive negative externalities that crippled the broader economy.[115] Yet, the existing disclosure mechanisms provided under the federal securities laws would likely be ineffective in preventing such negative externalities as these instruments are often too complex to depict. The vast majority of these transactions were also considered private and were therefore exempt from significant regulation.[116] This Part concludes with a focused discussion of the banking industry because many of these institutions were deemed "too big to fail" and were thus given massive bailout payments.[117] This deepened the adverse impact that such institutions had on the broader economy.[118]

A. Federal Regulation of "Publicness"

Financial institutions that are characterized by varying degrees of "publicness" are subject to an intricate web of federal regulation.[119] More specifically, when the internal "private" decisions of financial institutions could adversely impact the general public, the federal government subjects such institutions

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causal chain of the financial crisis.").

115. *See id.* at 8 ("Global financial liberalization permitted the migration [of] toxic subprime mortgages to banks around the world. Global credit markets ultimately collapsed under the weight of this excessive risk.").

116. *See* Shelby, *Are Hedge Funds Still Private?*, *supra* note 46, at 424 (2016) ("In passing the foundational Securities Act, Congress specifically noted that the laws were not intended to cover transactions 'where the public benefits are too remote.'" (citing H.R. REP. NO. 73-85, at 5 (1933))).

117. RAMIREZ, LAWLESS CAPITALISM, *supra* note 3, at 9.

118. *See id.* (discussing the government's bailout of U.S. banks and subsequent financial losses).

119. *See* Shelby, *Are Hedge Funds Still Private?*, *supra* note 46, at 422–25 (providing an in-depth discussion of how "publicness" is defined under the federal securities laws).

to layers of registration requirements and restrictions.[120] Banks, for example, are subject to significant federal oversight due to the economy's reliance on these institutions for the creation and transmission of capital.[121] The banking industry is therefore strongly interconnected with other financial institutions, and a bank failure often precipitates a financial crisis.[122] As a result, federal banking regulations include specific capital and reserve requirements, governance mandates, detailed licensing standards, and several other mandates.[123] The Federal Deposit Insurance Corporation (FDIC) also provides government-funded insurance for all bank deposits not exceeding $250,000,[124] which helps to "reduce systemic risk caused by a lack of confidence in the entire banking industry during times of economic distress."[125]

In addition, financial institutions that are publicly offered to investors, or publicly traded on an exchange, must comply with a web of federal legislation under the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act).[126] Following the Great Depression, Congress

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120. *See id.* at 438–39 (highlighting the Financial Stability Oversight Council's role in determining whether an institution's private decisions will impact the broader public).

121. *See, e.g.*, João A. C. Santos, *Bank Capital Regulation in Contemporary Banking Theory: A Review of the Literature*, 10 FIN. MKTS. INSTITUTIONS & INSTRUMENTS 41, 49–53 (2000) (explaining theoretical justifications for regulation of the banking industry).

122. *See generally* David Min, *Understanding the Failures of Market Discipline*, 92 WASH. U. L. REV. 1421 (2015) (summarizing the market discipline approach for regulating the banking industry).

123. *See generally* MICHAEL P. MALLOY, PRINCIPLES OF BANK REGULATION (3d ed. 2011) (summarizing and analyzing the various rules and regulations impacting depository institutions); Henry T. C. Hu, *Disclosure Universes and Modes of Information: Banks, Innovation, and Divergent Regulatory Quests*, 31 YALE J. REG. 565 (2014) (describing various disclosure mandates that are generally applicable to banks).

124. *Understanding Deposit Insurance*, FED. DEPOSIT INS. CORP., https://www.fdic.gov/deposit/deposits (last updated Apr. 26, 2016) (last visited Dec. 15, 2016) (on file with the Washington and Lee Law Review).

125. Mehrsa Baradaran, *Banking and the Social Contract*, 89 NOTRE DAME L. REV. 1283, 1316 (2014) [hereinafter Baradaran, *Banking and the Social Contract*].

126. *See The Laws That Govern the Securities Industry*, U.S. SEC. & EXCHANGE COMMISSION, https://www.sec.gov/about/laws.shtml. (last updated June 10, 2013) (last visited Dec. 15, 2016) (providing a broad overview of various

drafted these laws to resolve the unique investor protection issues that naturally arise with the sale of securities.[127] Given that securities are intangible instruments, investors must rely on underlying companies to provide meaningful information regarding their shares.[128] The unscrupulous dealings of issuers, including their collective unwillingness to disclose accurate information related to their offerings, led to billions of dollars of losses for the investing public in the midst of the Great Depression.[129]

As such, Congress incorporated a mandatory disclosure framework within the inaugural Securities Act as it requires that issuers provide investors with material information with respect to the initial issuance of securities.[130] Required disclosures include detailed descriptions of the use of proceeds, a discussion of the various management functions, an explanation of the multiple risk factors related with the investment, audited financial statements, and several other categories of information.[131] With the disclosure of this information, investors are better equipped to optimize their decisions on how to best allocate their limited capital. For the sake of clarity, regulators do not determine the quality of a particular offering under these laws, but rather they equip investors with the

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securities laws) (on file with the Washington and Lee Law Review).

127. *See What We Do*, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/about/whatwedo.shtml (last updated June 10, 2013) (last visited Dec. 15, 2016) [hereinafter *What We Do*] (providing a broad overview of the Securities and Exchange Commission's history, duties, and organizational structure) (on file with the Washington and Lee Law Review).

128. Intangible assets and instruments have been defined as "resource[s] which [do] not have a physical embodiment and whose industrial and economic exploitation gives a claim to future benefits." Vittoro Chiesa et al., *Determining the Value of Intangible Assets—A Study and an Empirical Application*, 5 INT'L J. INNOVATION & TECH. MGMT. 123, 124 (2008).

129. *See What We Do*, *supra* note 127 ("Tempted by promises of 'rags to riches' transformations and easy credit, most investors gave little thought to the systemic risk that arose from widespread abuse of margin financing and unreliable information about the securities in which they were investing.").

130. *See* Securities Act of 1933, 15 U.S.C. §§ 77j–77k (2012) (stating that the Securities and Exchange Commission may suspend trade in a security if an issuer's disclosures contain false statements or omissions of material fact).

131. *See id.* § 77j ("Any prospectus shall contain such other information as the Commission may by rules or regulations require as being necessary or appropriate in the public interest or for the protection of investors.").

necessary information to make such determinations on their own. Even if investors never read these disclosures, the efficient market hypothesis posits that publicly released information will be automatically impounded into share prices, thereby enhancing the reliance on such prices as a true reflection of the company's value.[132] Issuers who fail to disclose such material information, either purposely or inadvertently, can be exposed to substantial civil liabilities under various provisions of the Securities Act.[133]

With respect to the Securities Act, Congress clarified that the law is not designed to apply to regulate transactions where the "public benefits are too remote."[134] Although Congress failed to provide a precise definition of the term "public," a series of SEC releases and Supreme Court opinions clarified that defining "public offerings" hinges on the status of investors, as opposed to the underlying characteristics of the corporation.[135] In particular, when companies restrict ownership to elite investors who have the resources to adequately protect themselves, such companies are exempt from the arduous registration requirements under the Securities Act.[136] The Supreme Court famously clarified the contours of publicness in *SEC v. Ralston Purina Co.*,[137] where it held that an offering to those who can "fend for themselves" is a transaction "not involving any public offering."[138] The Court reasoned that if offerees have access to the same type of information that would be available in a registration statement,

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132. *See* Burton G. Malkiel, *Is the Stock Market Efficient?*, 243 SCIENCE 1313, 1313 (1989) ("[The hypothesis] states that the stock market is remarkably efficient in adjusting to, and reflecting in a rational way, all relevant information concerning individual stocks and the economy as a whole.").

133. *See* Securities Act of 1933, 15 U.S.C. §§ 77k, 77*l*, 77q (2012) (detailing penalties related to fraudulent registrations, disclosures, and interstate transactions); *see also* Securities Exchange Act of 1934, 15 U.S.C. §§ 78j, 78f (2012) (mandating that certain information must be included in registrations of securities and prospectuses).

134. H.R. REP. NO. 73-85, at 5 (1933).

135. *See infra* notes 136–142 and accompanying text (identifying a series of regulations and Supreme Court decisions which shaped and refined the legal concept of publicness).

136. *See* 17 C.F.R. §§ 230.501–508 (2016) (outlining the registration exemptions available to investors which meet the requirements of Regulation D).

137. 346 U.S. 119 (1953).

138. *Id.* at 125.

then they do not need the protections guaranteed under the Securities Act.[139]

In 1982, the SEC provided additional guidance in constructing private offerings when it promulgated Regulation D.[140] This safe harbor coined a new term, "accredited investors," which provides a bright-line definition for investors who can properly fend for themselves.[141] Such investors include individuals who earn over $200,000 per year, as well as a variety of institutions, such as banks, insurance companies, and pension plans.[142] In contrast, issuers that offer securities to large numbers of unaccredited investors (also known as retail investors) must register under the federal securities laws.[143] Thus, defining "public" in the context of the Securities Act entails evaluating characteristics of investors for which financial institutions have a prospective or existing contractual relationship. Assessing publicness does not extend to the impact that such institutions have on unrelated stakeholders such as employees, the environment, or the public at large.

While the Securities Act primarily regulates the flow of information related to the initial issuance of securities, the Exchange Act regulates the disclosure of information related to securities traded on the secondary markets.[144] Broadly prohibiting fraud in connection with the sale of securities is also an integral component of this legislation.[145] Financial institutions that fall

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139. *See id.* ("We agree that some employee offerings may [be exempt], e.g., one made to executive personnel who because of their position have access to the same kind of information that the act would make available in the form of a registration statement.").

140. *See* 17 C.F.R. §§ 230.501–508 (2016) (offering registration exemptions to those investors who meet certain requirements under Regulation D).

141. *See id.* § 230.501(a) (providing the definition of accredited investor).

142. *Id.*

143. *See* Securities Act of 1933, 15 U.S.C. § 77j (2012) (detailing which information is required in a registration prospectus); *see also* Securities Exchange Act of 1934, 15 U.S.C. § 78*l* (2012) (detailing registration requirements for trading securities on national exchanges).

144. *See* 15 U.S.C. § 78b ("[T]ransactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto . . . .").

145. *See id.* §§ 78j & 78f (providing auditing requirements and penalties associated with violations of those requirements).

within the definition of "public company" must comply with the periodic disclosure requirements under the Exchange Act.[146] The definition of public company under the Exchange Act includes the following three categories of issuers: (1) issuers that have securities listed on an exchange;[147] (2) issuers with "total assets" exceeding ten million dollars and classes of equity securities held by at least 2,000 persons (or 500 persons who are not accredited investors);[148] and (3) any issuer that files a registration statement under the Securities Act.[149] Financial institutions could potentially fall under any of these categories of public company due to their size, number of holders, and/or registration status under the Securities Act. As a result, companies must file the periodic reports mandated under the Exchange Act unless an available exclusion or exemption applies to the underlying entity.[150] Thus, defining "public" in the context of the Exchange Act largely entails evaluating both the size and the number of investors of a particular company. Similar to the Securities Act, assessing publicness does not extend to the impact that such institutions have on unrelated third parties.

B. Financial Innovation and Complexity

The rapid proliferation of complex and innovative financial products has expanded the overall impact that certain financial institutions have on the general public.[151] In particular, countless

146. *See id.* § 78m (detailing and outlining the periodic reporting requirements imposed on issuers of securities under the Exchange Act).

147. *See id.* § 78*l*(a) ("It shall be unlawful for any member, broker, or dealer to effect any transaction in any security (other than an exempted security) on a national securities exchange unless a registration is effective as to such security for such exchange . . . .").

148. *See id.* § 78*l*(g) (establishing a threshold at which a company must register its securities).

149. *See id.* § 78*l*(f)(1)(G) (indicating when a security is the subject of an initial public offering).

150. *See id.* § 78*l*(g) (outlining exemptions to the general periodic reporting requirements of the Exchange Act).

151. *See* Margaret M. Blair, *Financial Innovation, Leverage, Bubbles and the Distribution of Income*, 30 REV. BANKING & FIN. L. 225, 234–51 (2010) (examining the explosion in financial innovation, including money market funds, junk bonds,

individuals, who had no prospective or existing contractual relationship with such institutions, have suffered dire consequences resulting from the supposedly "private" decisions of publicly traded entities. For instance, large banking institutions played a pivotal role in creating the instruments that precipitated the financial crisis.[152] These institutions created and sold innovative financial instruments such as credit default obligations (CD"), credit default swaps "CD"), and other exotic derivatives.[153] These instruments essentially gave banks the power to repackage and sell debt to a variety of market participants, which led to a robust credit market that evaded significant oversight under the federal securities laws.[154] These products initially improved the facilitation of credit for countless individuals.[155] However, the growth of these markets "introduce[ed] new and unregulated types of leverage into the system . . . mak[ing] them very vulnerable to external shocks."[156] When the speculative bubbles associated with these instruments inevitably burst, the resulting losses to the general public were staggering.[157]

Many of these complex transactions were considered "private offerings" and were thus exempt from regulation under the federal securities laws. Since banks, insurance companies, hedge funds, mutual funds, and other institutional investors are considered

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private investment funds, asset securitization, derivatives, and repurchase agreements).

152. *See* Stout, *supra* note 3, at 19–20 (2011) (arguing that the deregulation of OTC derivatives under the Commodities Futures Modernization Act of 2000 was a major contributor to the financial crisis).

153. *See* RAMIREZ, LAWLESS CAPITALISM, *supra* note 3, at 83 ("The market for over-the-counter derivatives soared to $595 trillion by 2007."); *see also* FIN. CRISIS INQUIRY COMM'N, *supra* note 18, at 27–38 (discussing the shadow banking system and its role in the 2008 financial crisis).

154. *See id.* (explaining that prior to the Dodd–Frank Act, credit derivatives were not subject to regulatory oversight by the CFTC).

155. *See* Steven Schwarcz, *Keynote Address: Understanding the Subprime Financial Crisis*, 60 S.C. L. REV. 549, 550 (2009) ("[T]he model enabled de facto income to be recognized, on a statistical basis, in order to enable the poor to borrow money and acquire homes.").

156. Hilary Allen, *The Pathologies of Banking Business as Usual*, 17 U. PA. J. BUS. L. 861, 873 (2015).

157. *See id.* at 873–74 (explaining the wide-reaching effects and economic damage which can result from the vulnerability of financial innovations).

"accredited investors," such investors are free to trade these instruments without providing disclosures available to the general public.[158] In fact, these institutional investors controlled a large portion of the CDO, CDS, and other niche markets, which have been widely identified as being the primary culprit of the financial crisis.[159] Over-the-counter derivatives were also specifically exempt from state and federal regulation under the Commodity Futures Modernization Act of 2000, which many have identified as being yet an additional culprit in facilitating the financial crisis.[160] These exemptions largely contributed to the creation of the "shadow banking" industry,[161] which refers to a network of "financial intermediaries involved in facilitating the creation of credit across the global financial system, but whose members are not subject to regulatory oversight."[162] While credit was historically created and managed by large banking institutions subject to prudential regulation, many OTC-derivatives created a mechanism for exempt entities to directly participate in such credit

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158. *See* 17 C.F.R. § 230.501 (2016) (defining an "accredited investor" for the purposes and exemptions of Regulation D).

159. *See, e.g.*, Photis Lysandrou, *The Real Role of Hedge Funds in the Crisis*, FIN. TIMES (Apr. 1, 2012), http://www.ft.com/intl/cms/s/0/e83f9c52-6910-11e1-9931-00144feabdc0.html (last visited Dec. 13, 2016) ("On the eve of the crisis at end-2006, hedge funds held about 47 per cent of the $3tn worth of CDOs while the banks held 25 per cent and insurance companies and asset managers held the remaining 28 per cent.") (on file with the Washington and Lee Law Review).

160. *See* FIN. CRISIS INQUIRY COMM'N, *supra* note 18, at xxiv ("The enactment of legislation in 2000 to ban the regulation by both the federal and state governments of over-the-counter (OTC) derivatives was a key turning point in the march toward the financial crisis.").

161. *See* Karin Matussek, *Hedge Funds Are Shadow Banks in Need of Regulation, Bafin Says*, BLOOMBERG BUS. (May 13, 2012, 6:01 PM) http://www.bloomberg.com/news/articles/2012-05-13/hedge-funds-are-shadow-banks-in-need-of-regulation-bafin-says (last visited Dec. 13, 2015) (reporting comments made by Germany's financial regulator on how hedge funds act and how they should be recognized) (on file with the Washington and Lee Law Review). *But see* ALT. INV. MGMT. ASS'N, THE ROLE OF CREDIT HEDGE FUNDS IN THE FINANCIAL SYSTEM: ASSET MANAGERS, NOT SHADOW BANKS 3 (2012) (arguing that hedge fund industry is a part of the asset management sector, as opposed to shadow banking and that "hedge funds generally do not engage directly in credit transformation").

162. *Shadow Banking System*, INVESTOPEDIA, http://www.investopedia.com/terms/s/shadow-banking-system.asp (last visited Dec. 15, 2016) (on file with the Washington and Lee Law Review).

markets.[163] These troubling loopholes under federal law permitted the exemption of such transactions from significant oversight, without considering that they would likely create negative externalities that would spread to the global markets.[164] Thus, the markets that facilitated the crisis were largely opaque, which complicated the process of deriving an appropriate regulatory response.

Even if such transactions were subject to federal oversight, the existing mechanisms for regulating public firms are likely ineffective in protecting the general public from the negative externalities discussed herein. Simply mandating the disclosure of highly complex instruments does little to protect unrelated stakeholders from the harms presented by such products.[165] In fact, many highly sophisticated investors did receive disclosures summarizing the risks of these complex instruments, but such disclosures were inherently inadequate.[166] As one commentator noted, "even when the institutions that develop these products honestly disclose the inherent risks to investors: the new products still add complexity and interconnectedness to the financial system, increasing the amount and obscuring the allocation of risk

163. See FIN. CRISIS INQUIRY COMM'N, *supra* note 18, at 48–49 (describing the deregulation of OTC markets through the 1990s and its relationship to the financial crisis).

164.

> [T]he OTC derivatives market was] unregulated and largely opaque, with no public reporting requirements and little or no price discovery. With the Lehman bankruptcy, participants in the market became concerned about the exposures and creditworthiness of their counterparties and the value of their contracts. That uncertainly caused an abrupt retreat from the market.

See id. at 363–64.

165. *See* Steven L. Schwarcz, *Disclosure's Failure in the Subprime Mortgage Crisis*, 3 UTAH L. REV. 1109, 1113–15 (2008) (explaining the causes behind the insufficiency of disclosures).

166.

> [M]ost, if not all, of the risks giving rise to the collapse of the market for securities backed by subprime mortgages were disclosed, yet the disclosure was insufficient, in part because complexity made the risks very difficult to understand . . . a typical offering of these securities is . . . hundreds of pages . . . .

Id. at 1110.

in the system as a whole."[167] Investment strategies that utilize derivatives are often too complex to depict, as even the most sophisticated of investors may encounter difficulties in fully understanding the associated risks.[168] Deriving valuation mechanisms often necessitate highly complex algorithms and computer programs that evade human understanding.[169] Overall, relying on such archaic disclosure mechanisms to protect investors from these innovative products may prove to be insufficient and will do little to mitigate future crises.

Company boards have also perpetuated a perverse culture of shareholder primacy, which tends to embody short-term gains to shareholder value, without providing due consideration to long-term stability.[170] This myopic focus on short-term shareholder value can lead to excessive risk taking behavior on the part of corporate management, which could adversely affect the long-term interests of shareholders, as well as third-party stakeholders (whose interests are often intertwined with the economic interests of shareholders).[171] In effect, boards that are making a good faith attempt to effectively manage their companies may be incentivized "to disregard the externalities of their actions."[172] With respect to the financial crisis, many company boards aggressively pursued the short-term profitability associated with riding the subprime mortgage bubble, without appropriately considering the long-term effects to firm stability, and to the economy at large.[173] This phenomenon is exacerbated by the prevalent practice of

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167. Allen, *supra* note 156, 872–73.

168. *See generally* Henry T. C. Hu, *Too Complex to Depict? Innovation, 'Pure Information,' and the SEC Disclosure Paradigm,* 90 TEX. L. REV. 1601 (2012).

169. *See* Allen, *supra* note 156, at 872–73 (explaining that even honest disclosures do not erase the difficulties created by the complexity of the instruments).

170. *See id*. at 885 (describing focus on short-term gain at the expense of long-term stability as part of the financial industry's culture).

171. *See generally* LYNN STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC (2012).

172. Allen, *supra* note 156, at 876.

173. *See id.* at 885 (describing the industry culture as lacking regard for others, uninterested in long-term stability, and focused only on the short-term).

compensating corporate management with company shares,[174] which can further incentivize corporate management to enhance the short-term value of their equity within the company.

C. Public Subsidies for Private Institutions

This faulty reliance on short-term shareholder value, coupled with the pervasive dependence on risky financial instruments, caused several prominent financial institutions to fail towards the end of 2008. Lehman Brothers, and several other firms filed for bankruptcy, which crippled the global economy.[175] As noted by a case study published by Yale School of Management, when Lehman Brothers Holdings, Inc. (Lehman) filed for bankruptcy in September 2008,

> [N]ever before had such a large financial institution failed—its operations, clients and counterparties spread across the globe. Its derivative book alone consisted of more than 900,000 contracts. Lehman's clients and counterparties experienced direct effects from its failure and disclosed millions of dollars of potential losses as they began to account for their exposures, but that was only a small fraction of the impact. The tremors from Lehman's demise reached well beyond its direct counterparties . . . Concern regarding its real estate assets, its large derivative book, and its significant involvement with collateralized debt obligations . . . soon "infected" the shadow banking system, contributing to a retraction of wholesale funding and a severe liquidity crisis for many firms, including many with no direct links to Lehman. [176]

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174. *See Addressing Gaps in the Dodd-Frank Act*, *supra* note 28, at 3 (explaining that this practice encourages corporate managers to engage in risky behavior to inflate the short-term value of the company).

175. *Why TARP Was Necessary*, U.S. DEP'T TREASURY https://www.treasury.gov/initiatives/financial-stability/about-tarp/Pages/Why-TARP-was-Necessary.aspx (last updated Nov. 15, 2016, 1:34 PM) (last visited Dec. 13, 2016) (on file with the Washington and Lee Law Review).

176. Rosalind Z. Wiggins & Andrew Metrick, *The Lehman Brothers Bankruptcy H: The Global Contagion*, YALE SCH. MGMT. 2 (Apr. 8, 2015), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2593081 (last visited Dec. 13, 2016) (on file with the Washington and Lee Law Review).

As evidenced by this excerpt, when a systemically important financial institution (SIFI)[177] such as Lehman, for example, experiences solvency-threatening losses, the adverse consequences could spread to governments, other firms, and the public at large.

Given the adverse effects of a SIFI's failure, the Treasury established the Troubled Asset Relief Program (TARP) "to help stabilize the U.S. financial system, restart economic growth, and prevent avoidable foreclosures."[178] Distressed financial institutions that were deemed "too big to fail" were able to request sizable subsidies from TARP, which allocated approximately $250 billion to these troubled institutions.[179] AIG alone was granted $70 billion in TARP funds in order to prevent its imminent failure.[180] Proponents of these programs reasoned that such bailouts were necessary as the failure of these institutions would constitute systemic risk events that would effectively decimate the global economy.[181]

Even still, the federal bailout of financial institutions was widely criticized as taxpayers, who were excluded from the private decision-making processes of these institutions, were forced to pay for their mistakes.[182] Some have estimated that the Treasury has realized billions of dollars in losses, and that the TARP program could encourage excessive risk-taking by financial institutions since corporate boards know that they can rely on a federal bailout in the event of a future crisis.[183] The Congressional Oversight

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177. *See* 12 U.S.C. § 5365(a), (d) & (i) (2012) (attempting to address the risks to stability posed by large financial companies).

178. *TARP Programs*, U.S. DEP'T TREASURY, https://www.treasury.gov/initiatives/financial-stability/TARP-Programs/Pages/default.aspx (last visited Dec. 15, 2016) (on file with the Washington and Lee Law Review).

179. *Id.*

180. *Id.*

181. *See id.* (crediting TARP with avoiding a second Great Depression).

182. *See, e.g.*, Moira Herbst, *Think the Bailout Cost US Taxpayers Nothing? Think Again*, GUARDIAN (May 28, 2013), https://www.theguardian.com/commentisfree/2013/may/28/bank-bailout-cost-taxpayers (last visited Dec. 15, 2016) (critiquing the bailout program for costing taxpayers billions of dollars and charging the government with painting a dishonestly rosy picture) (on file with the Washington and Lee Law Review).

183. *See* Halah Touryalai, *Don't Be Fooled, There's No Profit in Bank Bailouts: TARP Watchdog*, FORBES (Apr. 25, 2012, 1:19 PM), http://www.forbes.com/sites/halahtouryalai/2012/04/25/dont-be-fooled-theres-no-profit-in-bank-bailouts-tarp-

Panel similarly recognized that "TARP . . . created moral hazard: [v]ery large financial institutions may decide to take inflated risks because they expect that, if their gamble fails, taxpayers will bear the loss."[184] As Professor Mehrsa Baradaran similarly noted,

> In giving this aid to the large banks, the government never explicitly demanded anything in return, and it quickly became apparent that banks would not use these funds for public-serving purposes. Instead, they shored up their balance sheets by saving their cash for a rainy day. Soon, the public also learned of bonuses given to bank executives with TARP funds. Clearly, the banking sector, which was not accustomed to meeting public needs, rejected their intermediary function—that it was their responsibility to take these government funds and lend.[185]

Many banks simply decided to retain TARP funds to enhance their internal balance sheets without appropriately using such funds to facilitate lending in the broader economy.[186]

As demonstrated by these critiques, the federal bailout of financial institutions greatly expanded the extent to which such entities could impact the general public. Congress responded by passing the Dodd–Frank Act as a means to implement creative and cost-effective solutions to protect the general public from these negative externalities.[187] With the passage of these laws, many financial institutions will necessarily have to consider the systemic risks of their operations, as well as the public interest in those operations, regardless of shareholder primacy and profit maximization.

The following Part IV continues this discussion by exploring the contours of risk management in the financial sector and the

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watchdog/ (last visited Dec. 15, 2016) (arguing that TARP has not achieved any kind of fundamental change to guard against a repeat of the financial crisis) (on file with the Washington and Lee Law Review).

184. *TARP Provided Critical Support but Distorted Markets and Created Public Stigma*, CONGRESSIONAL OVERSIGHT PANEL (Mar. 16, 2011), https://cybercemetery.unt.edu/archive/cop/20110401223120/http://cop.senate.gov/press/releases/release-031611-final.cfm (last visited Dec. 15, 2016) (on file with the Washington and Lee Law Review).

185. Baradaran, *Banking and the Social Contract*, *supra* note 125, at 1322.

186. *Id.*

187. *See id.* (referencing the Dodd–Frank Act's stated goal of strict oversight of financial institutions posing a systemic risk to the economy).

evolution of risk management theory. It examines the theory of risk management concerns and offers examples of two recent risk management failures. Part IV also highlights the limitations of various solutions proposed under the Dodd–Frank Act, and builds upon the growing body of empirical research that demonstrates that increasing heterogeneous management is a highly effective tool in protecting against the harms that facilitated the financial crisis.

IV. Systemic Risk and Risk Management

Over several centuries, commercial market participants have developed methods for addressing these types of risks. Contemporary innovation in financial markets, however, has altered the landscape of risk oversight in financial markets. This Part contends that mitigating risks similarly requires greater flexibility and creativity. Drawing on the observations in empirical data, this Part argues that studies evaluating the benefits of leadership diversity and diverse-group decision-making offer an important and underexplored path toward mitigating individual institutional risk management failures and industry-wide systemic risk concerns.

A. Risk Regulation in Financial Markets

For almost a century, state and federal regulatory agencies engaged in oversight of risks in financial markets.[188] Scholars and commentators analyze regulatory oversight through a variety of lenses.[189] While risk oversight regulation follows common regulatory trends, a survey of affirmative legislative and regulatory action reveals that innovation transforms markets and leads to evolutions in our understanding of risk.

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188. *See* Mehrsa Baradaran, *Regulation by Hypothetical*, 67 VAND. L. REV. 1247, 1253–55 (2014) [hereinafter Baradaran, *Regulation by Hypothetical*] (tracing the history of banking regulation since the Great Depression).

189. *See, e.g.*, Donald C. Langevoort & Robert B. Thompson, *'Publicness' in Contemporary Securities Regulation after the JOBS Act*, 101 GEO. L.J. 337, 339 (2013) (depicting regulation as a public-private dichotomy).

Since the Great Depression, scholars have identified five commonly depicted periods of financial market regulation.[190] Each of these periods offer insight into Congress's and regulators' earliest notions of risk—the ideas that (1) risk is local; (2) risk relates to activities; (3) insuring against risks requires capital buffers; (4) risk disclosures mitigate against risk; and (5) risk modeling illuminates risk exposure.[191] Characterizing the current period of regulatory oversight as "regulation by hypothetical," Mehrsa Baradaran identifies a final category of risk regulation that entails regulation predicated on agency and market participants' predictions of future risk scenarios.[192] Legislative mandates and regulatory agency actions reflect this history.[193]

While evaluation of the history and development may offer a much needed appreciation for the shifts in risk management theory, a detailed history of risk regulation in banking is beyond the scope of this Article. A few selected, historical reflections, however, indicate that legislation and regulation are poised to adapt to developments in our understanding of genuine risks to better ensure the safety and soundness in financial markets.

Critics rightly chided regulators for their parochial perceptions of risk and risk management across several regulatory periods. While unit banking may have limited the systemic risk concerns that animated much of the financial crisis, limiting banking activity for a specific bank to a particular state or geographic region did little to prevent banks from engaging in excessive risk taking. All of the thoughtfulness about isolating risks offered little solace to depositors who lost savings or homes in the bank runs in the 1920s. Congress's and regulators' willingness to adapt, though admittedly at a glacial pace, has been critical to maintain the international competitiveness of the United States banking sector.

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190. *See generally* Baradaran, *Regulation by Hypothetical, supra* note 188 (tracing the history of banking regulation since the Great Depression).

191 *Id.*

192 *Id.*

193. *See id.* at 1256–72 (describing various historical government measures implementing the different regulatory regimes).

Subsequent periods witnessed an erosion of Congressional and regulatory reliance on disclosure of banking activities that were limited under the National Bank Act.[194] The rise of over-the-counter derivatives provides the most prominent example of such a change.

In the mid-1980s the Federal Reserve agreed to permit bank affiliates to engage in securities underwriting transactions.[195] The capital markets transactions exposed the banks to market risk, heightening the banks' desire to identify hedging or risk management strategies.[196] A series of decisions by the Office of the Comptroller of the Currency authorized banks to enter into and serve as dealers in over-the-counter (OTC) derivatives transactions.[197] By 1984, the Federal Home Loan Bank Board began to underscore banks boards' obligations to manage risks by adopting policies requiring bank boards to periodically report on interest rate risk exposure.[198] To facilitate ingenuity in the development of derivatives, market participants lobbied to exclude the OTC derivatives used to hedge against risk from regulatory oversight and the Commodities Futures Trading Commission consented.[199]

In 1986, the Basel Committee on Banking Supervision offered some guidance for employing risk management techniques such as

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194. *See* Baradaran, *Regulation by Hypothetical, supra* note 188, at 1261 (describing this shift in banking activities and in regulation).

195. *See* Robert Weber, *A Theory for Deliberation-Oriented Stress Testing Regulation*, 98 MINN. L. REV. 2236, 2250–51 (2014) (describing this shift in risk management as a response to increased exposure that began in the 1980s).

196. *See id.* (noting that the driving force in these developments was the increased exposure).

197. *See generally* Saule T. Omarova, *The Quiet Metamorphosis: How Derivatives Changed the "Business of Banking"*, 63 U. MIAMI L. REV. 1041 (2009) (tracing the history of derivative regulation).

198. *See* Interest-Rate-Risk Management; Policy Statement and Final Rule, 49 Fed. Reg. 27,295–96 (July 3, 1984) (establishing such reporting requirements).

199. *See* Trading in Foreign Currencies for Future Delivery, 50 Fed. Reg. 42,983, 42,985 (Oct. 23, 1985) (discussing the various types of instruments that will remain unregulated); Policy Statement Concerning Swap Transactions, 54 Fed. Reg. 30,694 (July 1, 1989) (providing a safe harbor from CFTC regulation for OTC swap transactions meeting specified requirements).

derivatives and other off-balance sheet transactions.[200] Other regulators proposed limits for derivatives transactions, heightened compliance policies, and internal controls.[201] The adoption of the Federal Deposit Insurance Corporation Improvement Act imposed further internal controls.[202] Other domestic and foreign banking regulators implemented similar permissive rules regarding risk management oversight, attempting to temper the concerns regarding nascent derivative products with greater internal controls.[203]

In 1993, the Office of the Comptroller of the Currency published Circular 277 and outlined the most significant sources of risks including market, credit, liquidity, legal, and operational risks.[204] Regulators began to ponder whether arguments in favor of hedging—a risk management strategy—justified permitting banks, particularly depository institutions, to act as dealers and engage in proprietary trading in the derivatives market. The Circular outlined three mandatory elements for all banking risk management programs: (1) board oversight of risk management; (2) a comprehensive risk management approach, including detailed limits for risk taking and a system for monitoring risks; and (3) internal and audit controls.[205]

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200. *See* Baradaran, *Regulation by Hypothetical, supra* note 188, at 1268 (describing the Basel framework and requirements).

201. *Id.*

202. *See* Federal Deposit Insurance Corporation Improvement Act of 1991 § 39, 12 U.S.C. § 1831p-1 (1991) (laying out a number of novel standards and an enforcement regime).

203. *See* U.S. GEN. ACCOUNTING OFFICE, FINANCIAL DERIVATIVES: ACTIONS NEEDED TO PROTECT THE FINANCIAL SYSTEM (1994) (raising concerns posed by the risks of derivatives), http://www.gao.gov/assets/160/154342.pdf; BASEL COMM. ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (1988) (last updated Apr. 1998) (requiring minimum levels of capital for international banks); Supervisory Policy Statement on Securities Activities, 57 Fed. Reg. 4,028 (Feb. 3, 1992) (updating and revising the FFIEC's policy on selection of securities dealers and requiring the establishment of prudent policies for transactions).

204. *Risk Management of Financial Derivatives*, OFF. COMPTROLLER CURRENCY (Oct. 1993), http://www.occ.gov/static/news-issuances/bulletins/pre-1994/banking-circulars/bc-1993-277.pdf.

205. BD. GOV. FED. RES. SYS., SR 93-69 (FIS), EXAMINING RISK MANAGEMENT AND INTERNAL CONTROLS FOR TRADING ACTIVITIES OF BANKING ORGANIZATIONS 1–3 (1993).

Notwithstanding the march toward enhanced risk management oversight within individual banking institutions—described as microprudential regulation—Congress amended the Commodities Exchange Act[206] (CEA) to supplement the CEA and add the Commodities Futures Modernization Act. The newly adopted legislation exempted OTC derivatives transactions from regulatory oversight on the basis that the market participants who engage in these transactions are sufficiently sophisticated to manage risks related to these instruments.[207] Even though subsequent acts by Congress emphasized internal controls within individual firms, all of these policies failed to appreciate the macroprudential risk management concerns burgeoning within financial markets. The implosion within financial markets less than a decade later firmly establishes that programs that focus exclusively on internal risk management ignore the growing risk management threats that reach across firms, the financial services industry, and the territorial borders of individual national jurisdictions.

While the Dodd–Frank Act created several mechanisms to regulate these risk management failures, such as the clearinghouse mandate under Title VII,[208] and increased regulation over SIFIs,[209] these measures may be insufficient in preventing a future financial crisis. With respect to the new clearing requirement, parties must become a member of an authorized clearinghouse or contract with a member of an authorized clearinghouse in order to trade certain OTC

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206. Commodity Exchange Act, Pub. L. No. 112-105, § 4c(a)(1)–(2), 42 Stat. 998 (1922) (codified as amended at 7 U.S.C. § 6c(a)(1)–(2) (2012)).

207. Responding to the Enron, Worldcom, and Tyco accounting scandals, however, Congress enacted the Sarbanes–Oxley Act in 2002, imposing greater compliance and internal control requirements for all businesses whose securities trade on national securities exchanges. Sarbanes–Oxley Act of 2002, Pub. L. 107-204, § 805(a)(5), 116 Stat. 745, 802 (2002) (codified at 28 U.S.C. § 994).

208. Dodd–Frank Act, Pub. L. No. 111-203, § 728, 124 Stat. 1376, 1695–97 (2010) (codified at 15 U.S.C. § 8323).

209. *See* 12 U.S.C. § 5323 (2012) ("The Council . . . may determine that a U.S. nonbank financial company shall be supervised . . . if the Council determines that material financial distress at the U.S. nonbank financial company . . . could pose a threat to the financial stability of the United States.").

derivatives.[210] However, this new clearing mandate could serve to transfer and concentrate systemic risk within clearinghouse entities.[211] With respect to the increased regulation over SIFIs, the Dodd–Frank Act empowered a new Financial Stability Oversight Council (FSOC) to designate a wide range of financial institutions as SIFIs.[212] Once an institution receives this designation, it is subject to heightened regulatory restrictions.[213] Even still, FSOC has made relatively few SIFI designations and the likelihood of private entities receiving such a designation (irrespective of their abilities to increase systemic risk) has significantly declined.[214] Overall, the Dodd–Frank Act seems to have complicated and extended the regulatory patchwork that applies to financial institutions, without directly addressing the increasing effect that these entities have on the general public.[215]

With respect, however, to the specific issue of risk management, Dodd–Frank did include at least two provisions that could limit excessive risk in the financial sector without compromising financial performance or profitability. The first is the requirement that large and systemically important firms

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210. *See Governing Financial Markets*, *supra* note 21, at 216 (explaining that the clearinghouse requirement "mitigates risk exposure by increasing the transparency in the industry and maximizing allocational efficiency").

211. *See id.* at 226 ("The concentration of risk within clearinghouses and among participants in the clearing industry requires careful evaluation and monitoring.").

212. *See* Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21,637, 21,637 (Apr. 11, 2012) (to be codified at 12 C.F.R. pt. 1310) (giving guidance on which financial institutions the Financial Stability Oversight Council may designate as a SIFI).

213. *See id.* at 21,653 (outlining which standards are imposed on nonbank financial institutions).

214. *Cf.* Andy Winkler, *Primer: FSOC's SIFI Designation Process for Nonbank Financial Companies*, AM. ACTION F. (Sept. 3, 2014), http://americanactionforum.org/research/primer-fsocs-sifi-designation-process-for-nonbank-financial-companies (last visited Dec. 15, 2016) (noting that a lack of transparency in the SIFI designation process creates uncertainty regarding the consequences of such a designation) (on file with the Washington and Lee Law Review).

215. *See* Shelby, *Are Hedge Funds Still Private?*, *supra* note 46, at 434–37 (critiquing ancillary law focus under Dodd–Frank Act and advises that increasing notions of publicness should be incorporated under primary legislation that regulates investment fund industry).

create enterprise wide risk management committees (and associated protections) to modulate excessive risk.[216] Second, the diversity initiative embodied in Section 342 also holds the promise of enhanced financial performance as well as risk mitigation.[217] In fact, as shown above, powerful evidence suggests that diversity particularly leads to superior risk management during periods of financial turbulence such as the financial crisis.[218]

Part V summarizes the general mechanics of this provision. Unfortunately, as will be further discussed below, the financial regulators ignored this lesson and materially diluted the impact of the statutory provision.[219] The remainder of this Article proposes

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216. *See* Johnson & Ramirez, *supra* note 36, at 412–16 (examining multiple legal and regulatory responses to failures in risk management leading up to the 2008 financial crisis).

217. *See* CREDIT SUISSE RESEARCH INST., THE CS GENDER 3000: WOMEN IN SENIOR MANAGEMENT 3–6 (2014), https://publications.credit-suisse.com/task/render/file/index.cfm?fileid=8128F3C0-99BC-22E6-838E2A5B1E4366DF (noting that "greater diversity in boards and management are empirically associated with higher returns on equity, higher price/book valuations and superior stock price performance," particularly during enhanced financial volatility in 2008). Of course, causation always presents problems of proof due to the constant possibility of omitted variables as well as the direction of causation. *Id.*

218. *See, e.g.*, Maureen I. Muller-Kahle & Krista B. Lewellyn, *Did Board Configuration Matter? The Case of US Subprime Lenders*, 19 CORP. GOVERNANCE: AN INT'L. REV. 405, 405 (2011) ("We find that the board configurations of those financial institutions that engaged in subprime lending were significantly different from those that did not. Specifically, subprime lenders had boards that were busier, had less tenure and were less diverse with respect to gender."); Marion Hutchinson et al., *Who Selects the 'Right' Directors? An Examination of the Association Between Board Selection, Gender Diversity and Outcomes*, 55 ACCT. & FIN. 1071, 1071 (2015) (finding that Australian companies with "greater gender diversity moderate[d] excessive firm risk which in turn improve[d] firms' financial performance").

219. As one SEC Commissioner argues:

> [T]he "voluntary, and let's hope for the best" approach taken by the Final Policy Statement is woefully inadequate and fails to meet Congressional mandate. Thus, a good opportunity to have real positive impact on diversity and inclusion has been squandered. As implemented, Section 342 will be reduced to a mere exhortation to regulated entities, many of which have not shown a commitment to achieve diversity in their companies.

Luis A. Aguilar, SEC Commissioner, *Dissenting Statement on the Final Interagency Policy Statement: Failing to Advance Diversity and Inclusion*, SEC. & EXCHANGE. COMMISSION (June 9, 2015), http://www.sec.gov/news/statement/dissent-interagency-policy-statement-diversity.html (last visited Dec. 13, 2016)

to reconfigure the approach the financial regulators now take to diversity, and to give the financial sector a more forceful push towards meritocracy—in the sense that superior risk management through diversity may well lead to superior long run financial performance.[220]

V. Regulating Diversity

As explained in prior parts of this Article, risk governance creates clear objectives that financial institutions can ill-afford to ignore. Successful risk management efforts will involve the use of a wide array of quantitative and governance tools. Board and senior management diversity is indisputably one such tool that has already been implemented by a number of states[221] as well as a number of other nations.[222] To its credit, Congress heeded this learning in adopting Section 342 of the Dodd–Frank Act.[223]

(on file with the Washington and Lee Law Review).

220. We take no position on affirmative action (that is, action designed to remedy the sordid racial history of the United States) in this paper, in the financial sector, or elsewhere. Instead we seek simply to encourage the world of finance to utilize all of the cognitive perspectives and experiences available to enhance performance and financial stability. For an extended discussion of the differences between morphological distinctions (underlying racial differences) and cognition-based distinctions (underlying different cultural experiences), see Steven A. Ramirez, *A General Theory of Cultural Diversity*, 7 MICH. J. RACE & L. 30, 40–67 (2001) (concluding that while race does not operate as a meaningful basis for cataloguing or understanding human genetic variation, it does operate socially to create diverse perspectives and experiences for purposes of superior group cognition).

221. *See, e.g.*, S. RES. S.1007, 189th Leg. (Mass. 2015); S. RES. HR0439, 99th Leg. (Ill. 2015); S. RES. 62, 2013–14 Sess. (Cal. 2013).

222. These bills seem to indicate that the United States is following European lead in the area of increasing gender diversity. *See* JULIE C. SUK, DEMOCRATIC DEFICITS & GENDER QUOTAS: THE EVOLUTION OF THE PROPOSED EU DIRECTIVE ON GENDER BALANCE ON CORPORATE BOARDS 1 (2014), www.fljs.org/sites/www.fljs.org/files/publications/Suk.pdf (noting that Norway adopted the world's first gender quota law in 2003, which required publicly traded companies to have no more than sixty percent of one gender on their boards under threat of dissolution for noncompliance). The European Union later proposed a directive in 2012 to improve gender diversity on corporate boards. *Id.* at 2.

223. Section 342 generated a fair amount of controversy, even hostility, upon its enactment. The *Wall Street Journal* opined that the provision would somehow lead to political allocation of credit:

Section 342 under the Dodd–Frank Act encourages greater diversity in the financial services industry.[224] This Part provides a succinct description of the mechanics of Section 342, which generally obligates a number of federal agencies to create Offices of Minority and Women Inclusion.[225] Such offices are charged with ensuring the fair inclusion and utilization of minorities and women in all business and activities of their respective agencies.[226] This Part highlights the more controversial aspect of Section 342, which further instructs these offices to create diversity standards for assessing the policies of its regulated entities.[227] These standards were finalized in June 2015.[228] However, compliance with such standards is purely voluntary, and federal agencies have permitted its regulated agencies to engage a self-assessment in determining

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> The law says this diversity czar will "ensure equal employment opportunity and the racial, ethnic and gender diversity" of the work force and senior management of these institutions. More ominously, this creature of Congress and the White House will also be charged with "increas[ing] the participation of minority-owned and women-owned businesses in the programs and contracts" of each agency and conducting "an assessment" of stated inclusion goals. Mull over that one for a minute. Having recently lived through a financial mania and panic caused in part by political pressure for "affordable housing," Congress will now order regulators to allocate credit by race and gender. Isn't the point of this financial reform supposed to be to make regulators better judges of systemic risks, which means focusing on financial safety and soundness? If the Waters provision passes, federal regulators will have to put racial and gender lending at the top of their watch list when they do their checks on the banks and hedge funds they are regulating.

Politicizing the Fed, WALL ST. J., http://www.wsj.com/news/articles/SB100014240527487045753045752971302992818 28 (last updated June 14, 2010) (last visited Dec. 13, 2016) (on file with the Washington and Lee Law Review). This opinion ignores that Section 342 specifically forbids any mandate regarding "lending policies and practices of any regulated entity." Dodd–Frank Act §342(b)(4). Indeed, standing alone, the assessment of diversity policies cannot "require any specific action" based solely on the findings of the assessment. *Id.*

224. *See* Dodd–Frank Act, Pub. L. No. 111-203, § 342, 124 Stat. 1376, 1541–45 (2010) (codified at 12 U.S.C. § 5452 (2012)) (listing the relevant agencies expected to comply with Section 342).

225. *Id.*

226. *Id.*

227. *See id.* (outlining affirmative steps agencies shall take to seek diversity in workforce).

228. *Id.*

the adequacy of such compliance, which seems contrary to the intent of Section 342.[229]

As will be further discussed below, the financial agencies failed in the implementation of Section 342 as the financial regulators adopted a weak interpretation of the Congressional mandate, which undermined Congressional efforts to ensure macroeconomic stability as well as sound macroprudential regulation.

A. Mechanics of Section 342

Several concerns inspired Congress to include Section 342, the Office of Minority and Women Inclusion[230] in the Dodd–Frank Act.[231] One concern was the manifest underrepresentation of minorities and women in the financial services industry[232] and in government financial service agencies,[233] as well as the lack of

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229. Indeed, the architects of Section 342 in Congress issued a letter to the financial regulators specifically highlighting their intent to impose diversity mandates upon regulated entities consistent with the thesis of this Article. *See* Honorable Maxine Waters et al., Letter to Participating Financial Agencies, April 14, 2014, http://democrats.financialservices.house.gov/uploadedfiles/signed_copy_of_letter_-_section_342.pdf. When the final guidelines were released Rep. Waters and Rep. Beatty released a statement expressing disappointment that "almost five years after the Dodd–Frank Act was enacted, our federal financial services agencies continue to provide lip service to important issues related to the diversity and inclusion of women and minorities in the financial services sector." *See Leading Democrats Express Concerns with Agency Diversity Standards*, U.S. HOUSE COMM. ON FIN. SERVS. DEMOCRATS (June 18, 2015) http://democrats.financialservices.house.gov/news/documentsingle.aspx?DocumentID=399208 (last visited Dec. 13, 2016) (on file with the Washington and Lee Law Review).

230. 12 U.S.C. § 5452 (2012).

231. Dodd–Frank Act § 342.

232. *See* 156 Cong. Rec. E1262-02 (daily ed. July 1, 2010) (speech of Hon. Sheila Jackson Lee of Texas) ("In addition, the bill requires expanded efforts to recruit and to retain minority and women financial services professionals, traditionally excluded from the upper ranks of management in most of the federal financial services regulatory entities.").

233. *See Minorities and Women in Financial Regulatory Reform: The Need for Increasing Participation and Opportunities for Qualified Persons and Businesses: The Hearing Before the Subcomm. on Oversight & Investigations, and the Subcomm. on Hous. & Housing & Cmty. Opportunity*, of *the H. Fin. Servs. Comm.*, 111th Cong. 3 (2010) (statement of Rep. Maxine Waters, Chairwoman, Subcomm.

employment and contracting opportunities available to women and minorities.[234] Research demonstrates that women represented only twenty-seven percent of senior executive managerial positions and minorities represented only ten percent of those positions.[235]

At the time of the passage of this act, only two of the twenty-five largest banks in America were headed by minorities and none by a woman, and only between four and five percent of all 8,000 or so American FDIC-insured banks were controlled by women and minorities.[236] Though financial institutions had often implemented diversity initiatives for fifteen years leading up to the passage of this act, management diversity at these institutions had "improved, but not changed substantially."[237] Among the concerns were that excluding diverse senior-level executives from making important decisions, especially in cases of emergency, led to excluding or not addressing challenges that minority- and women-owned businesses faced[238] and led to not prioritizing diversity.[239]

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on Hous. & Cmty. Opportunity), https://www.gpo.gov/fdsys/pkg/CHRG-111hhrg58045/pdf/CHRG-111hhrg58045.pdf [hereinafter *The Dodd–Frank Wall Street Reform Joint Hearing*] (citing data from multiple government financial services agencies showing single digit percentages of women and minority employees).

234. *See id.* ("In addition, minority- and women-owned businesses frequently find themselves excluded from contracting opportunities with financial services agencies.").

235. *See id.* at 4–5 (statement of Orice Williams Brown, Director, Financial Markets and Community Investment, Government Accountability Office) (noting that older statistical categories overstated the representation of women and minority representation in upper management); *Overall Trends in Mgmt.-Level Diversity & Diversity Initiatives*, *1993-2008*, UNITED STATES GOV'T ACCOUNTABILITY OFFICE 10 (May 12, 2010), http://www.gao.gov/new.items/d10736t.pdf (breaking down representation by minority groups).

236. *The Dodd–Frank Wall Street Reform Joint Hearing*, *supra* note 233, at 18–19 (statement of Carlos Loumiet).

237. *Id.* at 5 (statement of Orice Williams Brown, Director, Financial Markets and Community Investment, Government Accountability Office).

238. *See id.* at 3–4 (statement of Maxine Waters, Chairwoman, Subcomm. on Housing & Community Opportunity) ("These offices would ensure that whether it is an emergency or if it is simply the day-to-day business of the agency, a senior level person charged with diversity will be . . . able to inform the agency about the impact of their decisions . . . .").

239. *See id.* at 29 (statement of Al Green, Subcomm. on Hous. & Cmty. Opportunity) (questioning witnesses on the lack of diversity-focused efforts by upper management officials).

Additionally, lack of diversity at the senior executive level minimized access for women and minorities[240] and correlated with less managerial accountability.[241] The executive director of the National Association of Securities Professionals, Orim Graves, testified at a Congressional hearing before this act was passed stating that "it is absolutely vital for the future economic and political stability of our nation that the investment decisions are made by a more diverse group than the one that created the economic crisis today and in the 1980s."[242]

Section 342 requires nine federal financial services agencies (the "Agencies")[243] to establish an Office of Minority and Women Inclusion (the "Offices") for the purpose of implementing "standards and procedures to ensure, to the maximum extent possible, the fair inclusion and utilization of minorities, women, and minority-owned and women-owned businesses in all business and activities of the agency at all levels, including in procurement, insurance, and all types of contracts."[244] These Offices were intended to ensure that a diverse senior-level executive would be

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240. *See id.* at 3 (statement of Maxine Waters, Chairwoman, Subcomm. on Housing & Community Opportunity) (commenting that minority and women owner businesses are often excluded from contracting opportunities).

241. *See id.* at 8 (statement of Orice Williams Brown, Director, Financial Markets and Community Investment, Government Accountability Office) (advocating for measurement of diversity efforts in businesses as a means of holding managers accountable for diversity performance); SIFMA, 2007 REPORT ON U.S. WORKFORCE DIVERSITY & ORGANIZATIONAL PRACTICES 5–6 (2007), https://www.sifma.org/uploadedfiles/for_members/hr_and_diversity_resources/for%20members_hr%20and%20diversity%20resources_2007%20diversity%20survey,%20executive%20report.pdf (providing an overview of data collected from survey).

242. *The Dodd–Frank Wall Street Reform Joint Hearing*, *supra* note 233, at 5 (testimony of Orim Graves).

243. *See Offices of Minority and Women Inclusion Created Under the Dodd-Frank Wall Street Reform and Consumer Protection Act: Frequently Asked Questions*, DEP'T TREASURY (Oct. 2010), http://www.treasury.gov/initiatives/wsr/Documents/FAQs%20-%20Offices%20of%20Minority%20and%20Women%20Inclusion%20-%20Oct%202010%20FINAL.pdf ("[T]he Departmental Offices of the Department of Treasury, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency . . . the Federal Reserve Banks, the Federal Reserve Board, the National Credit Union Administration, the Securities and Exchange Commission, and . . . Consumer Finance Protection Bureau . . . .").

244. 156 Congress. Rec. § 5902, 5908 (July 15, 2010).

in the room for daily business decisions as well as decisions in an emergency situation who could "inform the [A]gency about the impact of their decisions on minority- and women-owned businesses."[245] These Offices were also intended to be responsible for increasing diversity within the Agencies[246] by developing and implementing workforce diversity standards.[247] The Offices would be in charge of "all matters of its agency related to diversity in management, employment, and business activities."[248] In short, these Offices were meant to ensure that diverse members sit at the decision-making table to protect the interests of women and minorities,[249] and that "capable, competent, and qualified" women and minorities had equal opportunity to be at the top.[250]

B. Diversity Standards for Regulated Entities

In effectuating the broad goals of the Section 342, each Agency must appoint a director (the "Directors") to oversee the

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245. *The Dodd–Frank Wall Street Reform Joint Hearing*, *supra* note 233, at 4 (statement of Maxine Waters, Chairwoman, Subcomm. on Hous. & Cmty).

246. *See id.* at 3–4 (reiterating the importance of institutionalizing access for women and minority groups through these offices).

247. *See*, *Offices of Minority and Women Inclusion Created Under the Dodd-Frank Wall Street Reform and Consumer Protection Act: Frequently Asked Questions*, DEP'T TREASURY (Oct. 2010), http://www.treasury.gov/initiatives/wsr/Documents/FAQs%20-%20Offices%20of%20Minority%20and%20Women%20Inclusion%20-%20Oct%202010%20FINAL.pdf (outlining other key duties of each Office of Minority and Women Inclusion).

248. *Id.*

249. *See The Dodd–Frank Wall Street Reform Joint Hearing*, *supra* note 233, at 8 (statement of Maxine Waters, Chairwoman, Subcomm. on Hous. & Cmty. Opportunity) ("[S]o there is someone who is sitting at the table who can say . . . do you not remember that we just had a subprime meltdown where minority communities were targeted . . . .").

250. *See id.* at 10 (statement of Al Green, Subcomm. on Hous. & Cmty. Opportunity); *About the Office of Minority & Women Inclusion*, SEC. & EXCHANGE COMMISSION (June 11, 2015), http://www.sec.gov/omwi/about-omwi (last visited Dec. 13, 2016) (stating the SEC's OMWI "is currently engaged in forming strategic collaborations and conducting outreach to diverse professional associations, organizations, and institutions" and "is proactively increasing awareness of the SEC's contracting needs by conducting outreach and providing technical assistance to expand opportunities to minority-owned and women-owned businesses") (on file with the Washington and Lee Law Review).

development of standards which broadly encompass: (A) "[an] equal employment opportunity and the racial, ethnic, and gender diversity of the workforce and senior management of the agency; (B) increased participation of minority-owned and women-owned business in the programs and contracts of the agency[;] . . . and (C) *assessing the diversity policies and practices of entities regulated by the agency.*"[251] Thus, in addition to developing standards intended to enhance diversity within their respective Agencies, Directors must also develop standards to assess the diversity policies of their regulated entities.[252] This section represents a broad commitment to enhanced diversity in the American economy. Arguably, with respect to the SEC for example, the agency must develop uniform standards for assessing the diversity policies of the thousands of public companies for which it regulates.[253] Some have estimated that the SEC regulates over "12,000 public companies, 5,500 broker-dealer firms, 670,000 stockbrokers, 4,600 mutual funds and 11,000-plus registered investment advisers."[254]

1. Joint Standards

In an effort to promote consistency, six of the nine Agencies adopted joint proposed standards on October 25, 2013, which were to be used by the Agencies' regulated entities to assess the effectiveness of their respective diversity policies.[255] On June 10,

251. 15 U.S.C. § 5452(b)(2) (2012) (emphasis added).

252. *See id.* at 5452(d) (stating the extent of the section's applicability to contracts of an agency).

253. *Cf. id.* at 5452(b)(3) ("Each Director shall advise the agency administrator of the impact of the policies and regulations of the agency on minority-owned and women-owned businesses.").

254. Quentin Fottrell, *10 Things the SEC Won't Tell You*, MARKETWATCH (Oct. 30, 2011, 7:02 PM), http://www.marketwatch.com/story/10-things-the-sec-wont-tell-you-1320000352729 (last updated Nov. 29, 2012) (last visited Dec. 13, 2016) (on file with the Washington and Lee Law Review).

255. *See* Proposed Interagency Policy Statement Establishing Joint Standards for Assessing the Diversity Policies and Practices of Entities Regulated by the Agencies and Request for Comment, 78 Fed. Reg. 64,052, 64,052 (proposed Oct. 25, 2013), http://files.consumerfinance.gov/f/201310_cfpb_final-diversity-standards-statement.pdf (giving background on the development of joint

2015, the Agencies then adopted a final interagency policy statement, which finalized these joint diversity standards (Joint Standards).[256] These Joint Standards address the following categories of activities with respect to such regulated entities: (1) organizational commitment to diversity and inclusion; (2) workforce profile and employment practices; (3) procurement and business practices and supplier diversity; and (4) practices to promote transparency of organizational diversity and inclusion.[257] Under each of these categories, the Agencies then provide specific standards that regulated entities can evaluate in assessing the suitability of their diversity policies.[258] The Agencies further specify that each of these standards could be tailored to the unique characteristics of each regulated entity such as size, number of employees, and total assets under management.[259]

Overall, these Joint Standards imply that diversity assessments should extend beyond the boardroom to include senior management, employees, and contractual relationships with suppliers and other possible sub-contractors.[260] With respect to supplier diversity for example, the Agencies suggest that firms attempt to provide "a fair opportunity for minority-and women-owned business to compete for procurement of business goods and services . . . ."[261] With regard to enhancing workforce diversity, the Agencies suggest that regulated entities recruit from institutions that serve large female or minority populations, such as Historically Black Colleges and Universities.[262]

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standards and seeking comment on their perceived effectiveness).

256. Joint Guidelines, *supra* note 44.

257. *See* 78 Fed. Reg. 64,052, 64,055–56 (providing summaries of the applicability of each category of standards).

258. *See id.* ("The Entity provides regular progress reports to the board and/or senior management.").

259. *See id.* at 64,055 ("For example . . . governance structure, revenues, . . . contract volume, geographic location, and community characteristics . . . .").

260. *See id.* (setting out standards that apply to both low-level employees and upper management).

261. 80 Fed. Reg. 33017.

262. *Cf.* OFFICE OF MINORITY AND WOMEN INCLUSION, FDIC, 2012 REPORT TO CONGRESS 12 (2012), https://www.fdic.gov/about/diversity/rtc_3_28_13.pdf ("[T]he FDIC's Corporate Recruitment Program continued in 2012 to maintain ongoing

However, this Article primarily evaluates the implementation of diversity standards related to management, which is the first category identified by the Agencies. Senior management would likely include the board members of a regulated entity, as well as its senior officers such as the CEO and CFO, for example. With respect to this first category, the Agencies suggest that regulated entities implement the following standard (among others): "[t]he entity takes proactive steps to promote a diverse pool of candidates, including women and minorities, in its hiring, recruiting, retention, and promotion, as well as in its selection of board members, senior management, and other senior leadership positions."[263] This standard is likely designed to ensure that a diverse pool of candidates is considered for the leadership roles of regulated entities.

The Joint Standards also provide that the term "diversity" specifically encompasses minorities and women, with "minorities" including "Black Americans, Native Americans, Hispanic Americans, and Asian Americans."[264] However, the Joint Standards permit regulated entities to use a more expansive definition.[265] An expanded definition of diversity could possibly include "individuals with disabilities, veterans, and LGBT individuals."[266]

2. Voluntariness

In adopting these Joint Standards, the Agencies clarified that assessing the diversity policies of regulated entities would not entail a traditional examination or supervision process.[267] More

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relationships with a wide range of colleges and universities to target a diverse talent pool for the CEP. These colleges and universities included 110 institutions designated as either minority-serving institutions or tribal colleges.").

263. 78 Fed. Reg. 64052, 64055.

264. 80 Fed. Reg. 33017.

265. *See id.* ("This language is intended to be sufficiently flexible to encompass other groups . . .").

266. *Id.*

267. *See* 78 Fed. Reg. 64,052, 64,054 (noting that many different types of assessments allow for both the Agencies and the public to understand diversity policies).

specifically, the Agencies seemingly will not employ their enforcement powers to ensure that their regulated entities are in compliance with the statute. Regulated entities are instead instructed to implement a self-assessment of their diversity policies, using the guidance provided under the Joint Standards.[268] While compliance with these Joint Standards is highly encouraged by the Agencies, it is still purely voluntary. Regulated entities will seemingly not face enforcement proceedings for failing to integrate these Joint Standards within their underlying policies and practices.[269] Disclosure of such compliance (or non-compliance) has also been deemed voluntary by the Agencies.[270] While the Joint Standards strongly encourage transparency—through the annual publication of diversity policies on company websites, for example—the Joint Standards clarified that such disclosure, both to the general public and to their respective Agencies, is completely voluntary.[271]

Many commenters appreciated the Agencies' decision to permit self-assessments. One comment letter published by several banking associations stated that "[r]egulated entities themselves are in the best position to assess their own diversity policies and practices. Many larger regulated entities already have well considered diversity policies and a track record of implementing, applying and developing those policies in the real world."[272] In contrast, other commenters expressed concerns that permitting

268. *See id.* (suggesting that the use of self-assessment promotes transparency and awareness within the entities).

269. *See* 80 Fed. Reg. 33,017 ("[T]he Agencies have added the following language: 'This document is a general statement of policy . . . . It does not create new legal obligations.'").

270. *See* 80 Fed. Reg. 33,020 (recounting that other commenters who claim that voluntary disclosure would conflict with congressional intent).

271. *See* 78 Fed. Reg. 64,052, 64,056 (stating that Agencies will use the disclosed information as resource in carrying out diversity efforts).

272. Comment Letter Relating to Proposed Interagency Policy Statement Establishing Joint Standards for Assessing the Diversity Policies and Practices of Entities Regulated by the Agencies and Request for Comment from the Consumer Bankers Ass'n, et al., 3 (Feb. 6, 2014), http://consumerbankers.com/sites/default/files/2014-02-06%20Joint%20Trades%20Letter%20Re%20Proposed%20Interagency%20Standards%20for%20Assessing%20Diversity%20Policies%20%28OMWI%29.pdf.

self-assessment would significantly detract from the stated goals of the act.[273]

SEC Commissioner Luis A. Aguilar strongly objected that in permitting self-assessments, the Agencies ignored the vast majority of comment letters received from "[m]embers of Congress, civil rights organizations, community-based organizations, professional associations, consumer advocacy groups, banking organizations, employer associations, financial services trade organizations, banks, credit unions, and individuals."[274] According to Commissioner Aguilar, these commenters persuasively argued that "voluntary self-assessments are ineffective because, without specific obligations and requirements, few regulated entities will conduct assessments or share assessment information."[275] If this is true, then Section 342 will have a minimal impact on actually increasing diversity in the financial sector. Americans for Financial Reform further suggested that Agency Offices should "devote staff and develop methodologies to conduct assessments of the entities that they regulate."[276]

With respect to the voluntary disclosure of such diversity policies, commentators similarly expressed concerns regarding the extent to which this would hold regulated entities sufficiently accountable. Professor Cheryl Nichols suggests that Congress intended that the disclosure of diversity policies by regulated

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273. *See Leading Democrats Express Concerns with Agency Diversity Standards*, U.S. HOUSE COMMITTEE ON FIN. SERVS. DEMOCRATS (June 18, 2015), http://democrats.financialservices.house.gov/news/documentsingle.aspx?DocumentID=399208 (last visited Dec. 13, 2016) ("[T]hese final rules . . . have the potential to undermine the meaningful progress Dodd–Frank made toward a more diverse financial sector.") (on file with the Washington and Lee Law Review).

274. Luis A. Aguilar, Commissioner, Sec. Exch. Comm'n, Dissenting Statement on the Final Interagency Policy Statement: Failing to Advance Diversity and Inclusion (June 9, 2015), http://www.sec.gov/news/statement/dissent-interagency-policy-statement-diversity.html (last visited Dec. 13, 2016) (on file with the Washington and Lee Law Review).

275. *Id.*

276. Comment Letter Relating to Proposed Interagency Policy Statement Establishing Joint Standards for Assessing the Diversity Policies and Practices of Entities Regulated by the Agencies and Request for Comment from the Americans for Financial Reform, 3 (Feb. 7, 2014), https://www.ncua.gov/Legal/CommentLetters/CLExtension20140207AFR.pdf.

entities be mandatory.[277] Nichols concludes that mandatory disclosure is necessary as it would provide the data needed to ascertain the efficacy of the statute.[278]

VI. Safety & Soundness and Diversifying to Mitigate Risk

As Part IV explained, Congress intended for Section 342 to reach businesses in the financial services sector whether organized as corporations that have distributed shares in public securities markets or limited liability companies or partnerships engaged in the shadow banking market intermediating credit. The Joint Standards encompass the weak standards that federal regulatory agencies have adopted to date. Regulators have power to reduce excessive risk taking and broad powers to order remedies concerning risk-taking innovation.[279] Financial regulators hold broad power to determine legal violations in the financial sector.[280] This Article suggests that financial regulators exercise these powers to further the full diversification of the financial sector in appropriate circumstances.[281] We will begin our assessment of the regulatory powers the federal financial regulators wield in the banking industry and then discuss the even broader powers the SEC holds to facilitate diversity.

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277. *See* Comment Letter Relating to Proposed Interagency Policy Statement Establishing Joint Standards for Assessing the Diversity Policies and Practices of Entities Regulated by the Agencies and Request for Comment from Cheryl Nichols 2 (Feb. 7, 2014), https://www.sec.gov/comments/s7-08-13/s70813-21.pdf ("The word 'shall' is ordinarily considered mandatory . . . .").

278. *See id.* (arguing that such data will be essential to determine whether more regulation is needed).

279. *See generally* MARY RAMIREZ & STEVEN RAMIREZ, THE CORPORATE DEATH PENALTY: RESTORING LAW AND ORDER IN THE FINANCIAL SECTOR 1–28 (2017) (analyzing the ability of politically and economically high-powered figured to commit financial crimes with no regulatory or criminal repercussions).

280. *See id.* (noting that, despite overwhelming proof of fraud during the 2008 financial crisis, the government failed to utilize its law enforcement tools).

281. We fully comprehend the complex political realities facing the financial regulators. The revolving door problem, lobby largesse, campaign contributions, and overlapping social networks are all beyond the scope of this Article. *Id.*

A. The Federal Banking Regulators

The starting point for understanding the powers of the federal bank regulators[282] is the concept of safe and sound banking practices: the banking regulators assure the safety and soundness of banks by sanctioning unsafe and unsound banking practices uncovered, *inter alia*, during annual examinations.[283] Since 1933, this bedrock principle of banking regulation has acted as the trigger of the federal banking regulators vast enforcement

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282. Only the OCC, the FDIC, and the Fed share enforcement powers as direct regulators of banks and similar depository institutions. 12 U.S.C. § 1813 (q), (z) (2012). The NCUA holds similar power with respect to federal credit unions. 12 U.S.C. § 1786 (2012). The Fed also exercises enforcement power against bank holding companies and non-bank subsidiaries under Section 1818. 12 U.S.C. § 1818 (b)(3) (2012). As used in this Article, the term "federal bank regulators" refers to these agencies. These regulators typical conduct annual bank examinations and evaluate the safety and soundness of each regulated bank. Julie Andersen Hill, *When Bank Examiners Get It Wrong: Financial Institution Appeals of Material Supervisory Determinations*, 92 WASH. U. L. REV. 1101, 1107 (2015)

> During an examination, regulators . . . review the institution's policies, procedures, and records. Examiners then rate the institution using the Uniform Financial Institutions Rating System. Under the System, regulators evaluate the safety and soundness of institutions using the "CAMEL" or "CAMELS" factors: capital, assets, management, earnings, liquidity, and susceptibility to market risk. Regulators rate each item on a 1 to 5 scale, with a 1 rating being the highest possible score." Examiners also award each institution a composite rating meant to assess the overall condition of the institution. The composite score is not simply an average of the component ratings. Rather, in issuing a composite rating the regulator considers the components and "may incorporate any factor that bears significantly on the [institution's] overall condition."

Id. We argue herein that the degree of cultural diversity within a financial institution should be one factor that regulators consider in addressing the safety and soundness of a financial institution.

283. Principles of safety and soundness form the foundation of federal bank regulation. *See* Heidi Mandanis Schooner, *Fiduciary Duties' Demanding Cousin: Bank Director Liability for Unsafe or Unsound Banking Practices*, 63 GEO. WASH. L. REV. 144, 165, 178 (1995) ("Unsafe or unsound banking practices long have served as a trigger for . . . liability under every important formal enforcement provision in the federal banking laws."). Under these provisions bank regulators can: issue cease and desist orders, including monetary damages; remove directors and officers from office; prohibit firms from participation in the banking industry; and impose fines of up to one million dollars per day. *Id.*

powers.[284] Although mentioned in many key banking law statutes, at the federal level, the term "unsafe and unsound banking practice"[285] has been defined primarily through regulatory statements and actions.[286] Most recently, the OCC defined the term in an enforcement action as "any action, or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk or loss or damage to an institution, its shareholders, or the agencies administering the insurance funds."[287] The federal banking regulators rely on this definition when exercising the broad enforcement powers that Congress gave them.[288] Notably, none of those statutes requires more.[289]

Thus, under 12 U.S.C. § 1818, the bank regulators may exercise broad powers to deal with any bank that engages in unsafe and unsound banking practices.[290] The FDIC, for example, can

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284. *See* 12 U.S.C. §§ 1786, 1818, 1844 (2012) (specifying the enforcement tools and powers of the NCUA, the OCC, the FDIC, and the Fed).

285. *In re* Adams, No. AA-EC-11-50, 2014 WL 8735096, at *2 (Sept. 30, 2014).

286. *See, e.g.*, *id.* (explaining that the Federal Deposit Insurance Act contains no definition of the term "unsafe or unsound practice" and asserting John E. Horne's definition is the primary definition used in enforcement actions).

287. *Id.* at *2–3 (citing *Financial Institutions Supervisory Act of 1966: Hearings on S. 3158 Before the H. Comm. on Banking and Currency*, 89th Cong., 2d Sess. 49 (1966) (statement of John E. Horne, Chairman of the Fed. Home Loan Bank Bd.)); *see also* Nw. Nat'l Bank v. U.S. Dep't of the Treasury, 917 F.2d 1111, 1115 (8th Cir. 1990) (defining the term "unsafe or unsound business practice" as "conduct deemed contrary to accepted standards of banking operations which might result in abnormal risk or loss to a banking institution or shareholder") (quoting First Nat'l Bank v. U.S. Dep't of the Treasury, 568 F.2d 610, 611 (8th Cir. 1978)).

288. *See id.* at *3 ("The OCC and the other Federal banking agencies consistently have relied on this definition in bringing enforcement cases in the decades since [Horne's description of the term]."); *see also id.* ("[A] minority of circuits apply the [Horne] definition with a restrictive gloss that serves to narrow the circumstances under which enforcement actions may be taken.") (citing Gulf Fed. Sav. & Loan Ass'n v. Fed. Home Loan Bank Bd., 651 F.2d 259, 267 (5th Cir. 1981) (referring to an additional requirement that the practice threaten the financial stability of the bank)).

289. Professor Schooner suggests that the unsafe and unsound practice must also involve "at least a potential risk to the bank's solvency." *Schooner*, *supra* note 283, at 202.

290. The plain meaning of the statute fails to require any threat to the financial stability of the bank. *See, e.g.*, *In re Adams*, 2014 WL 8735096, at *3–4

terminate the deposit insurance of any insured depository institution for "engaging in any unsafe and unsound practices" or operating in an "unsafe and unsound condition."[291] In addition, all federal bank regulators can issue cease and desist orders to any federally regulated bank to stop any "unsafe or unsound practice."[292] The agencies can remove any officer or director of a regulated entity if it finds that any officer or director "participated in any unsafe or unsound practice . . . ."[293] The federal banking regulators can also force an insured bank into conservatorship or receivership for unsafe or unsound practices, or for operating in an unsafe or unsound condition.[294] Finally, the agencies can seek civil penalties for unsafe and unsound practices of up to one million dollars per day.[295]

(describing the range of possible remedies enforcement staff may take against banks). It is difficult if not impossible to reconcile the decisions that narrow the regulatory reach of the enforcement power of the federal bank regulators with the Federal Deposit Insurance Corporation Improvement Act of 1991. *See generally* Pub. L. No. 102-242, 105 Stat. 2236 (1991) (codified in scattered sections of 12 U.S.C.). Section 1831o of title 12 of the United States Code requires the federal banking regulators to take "prompt corrective action" even against well-capitalized depository institutions when the regulators find unsafe or unsound practices. *See* 12 U.S.C. § 1831o(a)(2) (2012) (requiring each appropriate federal banking agency take "prompt corrective action" to resolve problems). "With the passage of the Federal Deposit Insurance Corporation Improvement Act of 1991, Congress directed the federal banking agencies to exercise their enforcement muscle long before an institution fails or faces imminent threat of failure." Schooner, *supra* note 283, at 178. This forces the regulators to assume a more formal and proactive role with regard to supervision of operating institutions. *Id.*

291. 12 U.S.C. § 1818 (a)(2) (2012).

292. *See id.* § 1818(b) (describing the cease and desist proceeding).

293. *See id.* § 1818(e)(1)(A)(ii) (allowing for the removal of officers of a regulated entity when the entity is found to have "engaged or participated in any unsafe or unsound practice in connection with any insured depository institution or business institution"). Any such prohibition amounts to an industry-wide prohibition. *See* 12 U.S.C. § 1818(e)(7) (2012) (requiring an "industrywide prohibition" on the hiring of removed or suspended individuals). Thus, this power can operate to terminate careers. *See id.* at § 1818(g) (providing authority for suspension, removal, and prohibition of participation orders for certain criminal offenses).

294. *See id.* § 1821(c)(5) (describing the grounds for appointing a conservator or receiver).

295. *See id.* § 1833(b)(2) (allowing an agency to assess civil penalties for continuing violations in an amount "[not to] exceed the lesser of $1,000,000 per day or $5,000,000").

In the course of enforcing these broad powers to assure safe and sound banking, the banking regulators can restrict the growth of an institution, place limitations on the activities of an institution, or, importantly, "employ qualified officers or employees" subject to the approval of the banking regulators.[296] Indeed, Congress specified that the federal banking regulators may "take such other actions as the banking agency determines to be appropriate."[297] Further, Congress statutorily recognized that the federal banking regulators may come to negotiated agreements with the banks they supervise, and violation of such agreements themselves trigger the above-referenced enforcement powers.[298] Finally, the federal banking regulators may deem a bank to be engaged in an unsafe and unsound banking practice if a bank receives an unsatisfactory rating in an examination report for asset quality, management, earnings, or liquidity.[299]

Congress gave the federal banking regulators additional regulatory power over virtually all core facets of banks.[300] Under 12 U.S.C. § 1831p-1, the federal banking regulators must promulgate standards for safe and sound internal controls, loan documentation and underwriting, interest rate risk, asset growth, compensation, and other managerial standards.[301] If any bank fails to meet such standards, then the federal banking regulator may seek a remedial plan, acceptable to the regulator.[302] If such a plan is not forthcoming, the relevant federal banking regulator

296. *See id.* § 1818(b)(6)(A)–(F) (listing the affirmative actions banking regulators may take to correct conditions resulting from violations or practices).

297. *Id.* § 1818(b)(6)(F).

298. *See id.* § 1818(a)(2)(iii), (b)(1) & (e)(1)(A)(i)(III)–(IV) (establishing a violation of a written agreement as cause for exercise of enforcement power).

299. *See id.* § 1818(b)(8) (providing that bank regulators may deem an institution to be "engaging in an unsafe or unsound practice" the institution is found to have unsatisfactory asset quality, management, earnings, or liquidity).

300. *See id.* § 1831p-1(a)(1)–(2) (listing each internal bank practice for which bank regulators may prescribe standards).

301. *See id.* § 1831p-1(a) (enumerating the operational and managerial standards federal banking agencies must enforce).

302. *See id.* § 1831p-1(e)(1)(A)(i) (explaining how if the failure to meet safety and soundness standards involves a violation of a regulation the federal banking regulator "shall" seek a corrective plan).

may order the bank to take "any other action"[303] necessary for the prompt correction of the deficiency.[304]

The Federal Reserve Board of Governors (Fed) holds additional powers with respect to bank holding companies. Specifically, under 12 U.S.C. § 1844, the Fed may order the termination of any activity or the divestiture of any subsidiary constituting a "serious risk" to the "financial safety soundness and stability" of the bank holding company or subsidiary bank.[305] The bank holding company may either terminate the activity that is the source of the risk, terminate its ownership of the non-bank subsidiary where the risk resides, or terminate ownership of its bank subsidiary.[306] Termination of ownership may be accomplished through sale or distribution of shares to shareholders of the bank holding company.[307]

Of course, the federal banking regulators need not exercise these powers in order to impose reforms if enforcement targets agree to proposed governance reforms. For example, the Fed recently sanctioned State Street Bank (a state-chartered member bank of the Federal Reserve System) and its parent company State Street Corporation (a bank holding company).[308] The Fed

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303. *Id.* § 1831p-1(e)(2)(B)(iv).

304. Section 1831o requires that "[e]ach appropriate Federal banking agency and the Corporation (acting in the Corporation's capacity as the insurer of depository institutions under this chapter) shall carry out the purpose of this section by taking prompt corrective action to resolve the problems of insured depository institutions." 12 U.S.C. § 1831o.

305. *See* 12 U.S.C. § 1844(e)(1) (allowing the Fed, "whenever it has reasonable cause to believe that the continuation by a bank holding company of any activity . . . constitutes a serious risk to the financial safety, soundness, or stability of a bank holding company subsidiary bank," to terminate the activities).

306. *See id.* § 1844(e)(1)(A)–(B) (reviewing the powers of the Fed to terminate activities, ownership, and control of nonbank subsidiaries).

307. *See id.* (explaining that the Fed may order the termination of ownership which may occur "by sale or by distribution of the shares of the subsidiary to the shareholders of the bank holding company").

308. *See* Written Agreement by and among, State Street Corporation, Boston, Massachusetts, State Street Bank and Trust, Boston, Massachusetts, Federal Reserve Bank of Boston, and Massachusetts Division of Banks, before the Federal Reserve Board of Governors, May 28, 2015, https://www.federalreserve.gov/newsevents/press/enforcement/enf20150601a1.pdf (describing the technicalities of the alleged noncompliance).

enforcement action culminated in an agreement that required State Street Corporation to, among other things: (1) submit a written plan to strengthen the board's oversight of compliance and risk management acceptable to the regulators with respect to money laundering and compliance with the U.S. Treasury Office of Foreign Asset Control; (2) address funding for personnel, systems, and other resources as needed to achieve appropriate risk management and compliance; (3) take measures to improve the information reported to the board of directors with respect to such compliance; (4) ensure greater senior management participation in such compliance efforts; and (5) provide for enhanced monitoring and testing of compliance with respect to such regulatory mandates.[309] State Street Bank also agreed to such enhanced measures to achieve compliance with regulations.[310] Additionally, the bank agreed to hire an independent third party to conduct a compliance review.[311] Essentially, "State Street Corp. was ordered by regulators to revamp its compliance programs after deficiencies were found related to internal controls, customer due-diligence procedures and transaction monitoring."[312] This agreed method of resolving regulatory deficiencies illustrates well the wide-ranging powers of the federal banking regulators to impose reforms in internal governance at regulated entities.[313]

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309. *See id.* at 1–3 (describing the mandated requirements for board oversight and a compliance risk management program).

310. *See id.* 1–2 (detailing the bank's commitment to bring operations into compliance with multiple different regulations).

311. *See id.* at 7 ("Within 30 days of this Agreement, the Bank shall engage an independent third party, acceptable to the Supervisors, to conduct a review of account and transaction activity . . . .").

312. Chelsey Dulaney & Ryan Tracy, *State Street Ordered to Improve Compliance Program*, WALL ST. J. (June 1, 2015), http://www.wsj.com/articles/state-street-ordered-to-improve-compliance-program-1433174224 (last visited Dec. 13, 2016) (on file with the Washington and Lee Law Review).

313. In another such example, the OCC fined HSBC $500 million and ordered it "to take comprehensive corrective actions to improve its BSA compliance program." *OCC Assesses $500 Million Civil Money Penalty Against HSBC Bank USA, N.A.*, DEP'T TREASURY (Dec. 11, 2012), http://www.occ.treas.gov/news-issuances/news-releases/2012/nr-occ-2012-173.html (last visited Dec. 13, 2016) (on file with the Washington and Lee Law Review). On the same date, the OCC "issued a separate cease and desist order to address deficiencies in the bank's enterprise-wide compliance program." *Id.* HSBC consented to both orders. *Id.*

The banking regulators also have the power to issue interpretive guidance to regulated entities. The FDIC—holding broad regulatory power due to its role as deposit insurer—issued such guidance regarding its expectations of officers and directors of FDIC insured banks.[314] The FDIC expects directors to maintain "competent management," to "establish[] business strategies and policies," and to take actions to assure legal compliance and compliance with principles of safety and soundness.[315] Officers are "responsible for compliance with applicable laws, regulations, and principles of safety and soundness."[316] Moreover, the FDIC expects managers "to respond promptly to supervisory criticism."[317] "When an institution becomes troubled, it is especially important that it have the benefit of the advice and direction of people whose

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314. The FDIC statement regarding fiduciary duties of officers and directors provides:

> The duty of care requires directors and officers to act as prudent and diligent business persons in conducting the affairs of the bank. This means that directors are responsible for selecting, monitoring, and evaluating competent management; establishing business strategies and policies; monitoring and assessing the progress of business operations; establishing and monitoring adherence to policies and procedures required by statute, regulation, and principles of safety and soundness; and for making business decisions on the basis of fully informed and meaningful deliberation. Officers are responsible for running the day to day operations of the institution in compliance with applicable laws, rules, regulations and the principles of safety and soundness. This responsibility includes implementing appropriate policies and business objectives. Directors must require and management must provide the directors with timely and ample information to discharge board responsibilities. Directors also are responsible for requiring management to respond promptly to supervisory criticism. Open and honest communication between the board and management of the bank and the regulators is extremely important.

New FDIC Guidelines Issued to Clarify the Responsibilities of Bank Directors and Officers, FDIC FIL-87-92 (Dec. 17, 1992), https://www.fdic.gov/regulations/laws/rules/5000-3300.html (last visited Dec. 13, 2016) [hereinafter *FDIC Guidelines*] (on file with the Washington and Lee Law Review). *See also* OCC, THE DIRECTOR'S BOOK 10–17, 19–47 (2010), http://www.occ.gov /publications/publications-by-type/other-publications-reports/The-Directors-Book.pdf (articulating similar standards applicable to federally chartered depository institutions).

315. *FDIC Guidelines*, *supra* note 314.

316. *Id.*

317. *Id.*

experience and talents enable them to exercise sound and prudent judgment."[318] The FDIC speaks with particular authority in this area because it is the sole federal regulator operating as a receiver for insolvent depository institutions[319] and has a legal mandate to pursue any fiduciary duty claims against former bank directors and officers.[320] In this connection, the FDIC emphasizes that in considering whether to pursue such claims it will assess whether managers complied with laws, regulations, and supervisory agreements or heeded regulator warnings.[321]

The upshot of all of this is that the federal banking regulators have broad power to address and remedy all issues relating to safe and sound banking practices. Anytime an insured depository institution engages in any unsafe or unsound practice, or is operating in an unsafe and unsound condition, the federal banking regulators can impose any conditions necessary to stem the risks of such practice as part of their normal enforcement powers and processes.[322]

Nothing in Section 342 of the Dodd–Frank Act limits the regulators' power to address and remedy issues. Section 342 limits the power to impose cultural diversity in only one way: "[N]othing in [Section 342(b)] may be construed to mandate any requirement on or otherwise affect the lending policies and practices of any

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318. *Id.*

319. *See* 12 U.S.C. § 1821(c)(2)(A)(ii) (2012) ("The Corporation shall be appointed receiver, and shall accept such appointment, whenever a receiver is appointed for the purpose of liquidation or winding up the affairs of an insured Federal depositor institution . . . .").

320. *See id.* § 1821(k)(1)–(3) (enumerating the liabilities of bank directors and officers).

321. *See FDIC Guidelines*, *supra* note 314 (stating that claims pursued often involve "[c]ases where a director or officer was responsible for []failure . . . to adhere to applicable laws and regulations" and that claims against "outside directors either involve insider abuse or situations where the directors failed to heed warnings . . . that there was a significant problem"). Between 1985 and 1992, the FDIC pursued claims against officers and directors about twenty-four percent of the time a bank failed. *Id.*

322. *See, e.g.*, 12 U.S.C. § 1818(b)(6)(F) (including the power to order the bank to "take such other actions as the banking agency determines to be appropriate" within the power to issue a cease and desist order); 12 U.S.C. § 1818(a)(2)(A)(iii), (b)(1) & (e)(1)(A)(i)(III)–(IV) (explaining that federal banking regulators always retain the power to come to negotiated agreements with banks found to engage in unsafe or unsound practices).

regulated entity, or to require any specific action based on the findings of the assessment."[323] This sole limitation does not impact the regulators' preexisting power to address unsafe and unsound banking practices and conditions, even if such violations also implicate weak diversity policies and practices as part of the unsafe or unsound banking practice and conditions.[324] The regulators also traditionally exercised their remedial power broadly and it would defy the intent of the political branches to limit the reach of the federal regulators to address diversity in the financial sector under the Dodd–Frank Act; they manifestly held the opposite intent.[325] The SEC has similarly used its enforcement powers to plumb the depths of internal governance at regulated entities, as the next section of this Article will show.

B. The SEC and the Securities Industry

The SEC's main concern is legal compliance and regulatory risk.[326] For example, 15 U.S.C. § 78o gives the SEC power to revoke

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323. Dodd–Frank Act § 342(b)(4), 12 U.S.C. § 5452(b)(4) (2012).

324. It is a fundamental canon of statutory interpretation that statutes should be construed in harmony with preexisting statutes and the implied repeals or limitations of pre-existing statutes are disfavored. *See* FDA v. Brown & Williamson Tobacco Corp., 529 U.S. 120, 133 (2000) (explaining that courts should interpret the statutes as a "symmetrical and coherent regulatory scheme" and "fit, if possible, all parts into a harmonious whole"); United States v. Spinelle, 41 F.3d 1056, 1059 (6th Cir. 1994) (citing Morton v. Mancari, 417 U.S. 535, 550 (1974)); Morton v. Mancari, 417 U.S. 535, 550 (1974) ("In the absence of some affirmative showing of an intention to repeal, the only permissible justification for a repeal by implication is when the earlier and later statutes are irreconcilable." (citing Georgia v. Pennsylvania R. Co., 324 U.S. 439, 456–57 (1945))). Indeed, "when two statutes are capable of co-existence, it is the duty of the courts, absent a clearly expressed congressional intention to the contrary, to regard each as effective." *Id.* at 551. *See also* Beckert v. Our Lady of Angels Apartments, Inc., 192 F.3d 601, 606 (6th Cir. 1999) ("Repeals by implication are not favored in the law and are permitted only when the earlier and later statutes are irreconcilable." (citing United States v. Spinelle, 41 F.3d 1056, 1059 (6th Cir. 1994))).

325. *See supra* note 229 (detailing the legislative intent behind the Dodd–Frank Act).

326. *See The Laws That Govern the Securities Industry*, *supra* note 126 ("[T]he Securities Act of 1933 has two basic objectives: require that investors receive financial and other significant information concerning securities being

the registration of broker-dealers, which is tantamount to the corporate death penalty as a broker-dealer cannot operate without an effective registration with the SEC.[327] For our purposes, the key provision authorizing such revocation is Section 78o(b)(4), which provides that suspension or revocation is authorized if either the broker-dealer (or any person associated with the broker-dealer): (1) commits any fraud-based crime; (2) is found civilly responsible for fraud-related offenses; (3) is found to have willfully violated any part of the federal securities laws or regulations thereunder; or, (4) willfully aids and abets such violation.[328] Of course, like the banking regulators, the SEC need not impose the corporate death penalty.[329] The statute specifies that the SEC may impose any "limitations on the activities, functions, or operations of . . . [the] broker or dealer."[330] Also, like the federal banking regulators, the SEC has the power to permanently bar individuals found to have violated the federal securities laws from the securities industry.[331]

The SEC illustrated this point with its record-setting settlement with Goldman, Sachs & Co. relating to its alleged fraudulent sale of securities-related subprime mortgages.[332] Not

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offered for public sale; and prohibit deceit, misrepresentations, and other fraud in the sale of securities.").

327. *See* 15 U.S.C. § 78o(b)(4) (2012) (authorizing the SEC to place restrictions on a broker's registration).

328. *See id.* § 78o(b)(4)(A)–(H) (enumerating the situations under which the SEC has the authority to suspend or revoke a broker's registration).

329. *See id.* § 78o(b)(4) (providing the SEC options to censure, place limitations on, suspend, or revoke broker registrations). There is an additional layer of regulation in the securities industry. Specifically, all broker-dealers must maintain membership in a self-regulatory organization (SRO) such as the New York Stock Exchange (NYSE). *See id.* at § 78o(b)(8) (requiring broker-dealers to register pursuant to 15 U.S.C. § 78o-3—with a self-regulatory organization—before the broker-dealer may affect any transaction).

330. *Id.* § 78o(b)(4).

331. *See id.* § 78o(b)(6) ("[T]he Commission, by order, shall censure, place limitations on the activities of such person, or suspend for a period not exceeding 12 months, or bar any such person . . . .").

332. *See Goldman Sachs to Pay Record $550 Million to Settle SEC Charges Related to Subprime Mortgage CDO*, SECURITIES & EXCHANGE COMMISSION, http://www.sec.gov/news/press/2010/2010-123.htm (last updated July 15, 2010) (last visited Dec. 15, 2016) ("Half a billion dollars is the largest penalty ever assessed against a financial services firm in the history of the SEC . . . .") (on file with the Washington and Lee Law Review).

only did Goldman pay $550 million to settle the claims of the SEC, it also acknowledged that material misrepresentations occurred in connection with the marketing of such securities and agreed to internal governance reforms.[333] More specifically, it agreed to:

> [R]emedial action . . . in its review and approval of offerings of certain mortgage securities. This includes the role and responsibilities of internal legal counsel, compliance personnel, and outside counsel in the review of written marketing materials for such offerings. The settlement also requires additional education and training of Goldman employees in this area of the firm's business.[334]

This settlement thus demonstrates again the power of the federal financial regulators over the internal governance of firms they regulate.[335]

The SEC regulates many entities beyond just broker-dealers. Indeed, the Joint Guidelines identify the SEC as the agency with the greatest number of regulated entities subject to the guidelines.[336] The regulated entities subject to the Joint Guidelines and SEC regulation include: investment advisers, investment companies, self-regulatory organizations (such as the NYSE),

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333. *See id.* ("In agreeing to the SEC's largest-ever penalty paid by a Wall Street firm, Goldman also acknowledged that its marketing materials for the subprime product contained incomplete information.").

334. *Id.*

335. More recently, the SEC settled charges with Merrill Lynch regarding its record keeping obligations for $11 million. *See Merrill Lynch Admits Using Inaccurate Data for Short Sale Orders, Agrees to $11 Million Settlement*, SEC. & EXCH. COMM'N, http://www.sec.gov/news/pressrelease/ 2015-105.html (last updated June 1, 2015) (last visited Dec. 15, 2016) (detailing a SEC action against Merrill Lynch) (on file with the Washington and Lee Law Review). Merrill also agreed to hire an independent consultant to assist in future record keeping obligations. *Id.* Merrill Lynch previously settled similar record keeping charges for $131 million involving claims that it had misled investors with respect to securities offerings. *See SEC Charges Merrill Lynch with Misleading Investors in CDOs*, SEC. & EXCH. COMM'N, http://www.sec.gov/News/PressRelease/Detail/Press Release/1370540492377 (last updated Dec. 12, 2013) (last visited Dec. 15, 2016) (detailing charged filed by the SEC against Merrill Lynch regarding an alleged failure to provide information to investors) (on file with the Washington and Lee Law Review).

336. *See* Joint Guidelines, *supra* note 44, at 33021 (explaining how the SEC estimated that 1,250 of its regulated entities would respond to a survey regarding diversity policies, which is 500 more respondents than the next closest agency).

rating agencies, and certain institutions involved in derivatives markets.[337] The SEC regulatory scheme with respect to each of these different types of financial institutions differs in important ways.[338] However, there are many common themes: each of these types of entities must register with the SEC; the SEC holds the power to revoke such registrations for a variety of reasons, including legal and regulatory violations; and the SEC conducts periodic examinations of each type of regulated entity.[339] Invariably, the SEC may also take action short of revoking registrations, which operates as a corporate death penalty.[340]

An example of the SEC's power to influence regulated entities is in its enforcement action against an investment company, Putnam Investment Management LLC. In late 2003, SEC settled claims against Putnam relating to alleged violations of the Investment Advisers Act of 1940[341] and the Investment Company Act of 1940.[342] The Commission found that Putnam committed fraud in connection with the purchase and sale of securities in the form of mutual fund shares.[343] Putnam failed to disclose self-

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337. *See id.* at 33020 n.6 (listing the primary federal financial regulator for various institutions identified in 12 U.S.C. § 1813(q)).

338. *See What We Do*, *supra* note 127 (describing the manner in which various industries are regulated).

339. *See id.* ("The Act also identified and prohibits certain types of conduct in the markets and provides the Commission with disciplinary powers over regulated entities and persons associated with them.").

340. An example of this power is 15 U.S.C. § 78o (b)(4), discussed above.

341. Investment Advisers Act of 1940, 15 U.S.C. § 80b (2000). The Court termed that the intent of the Investment Advisers Act—like the federal securities laws in general—"was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry." SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963). The Act accomplished this through broad anti-fraud provisions that supported private claims and registration of investment advisers. *See* Goldstein v. SEC, 451 F.3d 873, 876 (D.C. Cir. 2006); Arthur B. Laby, SEC v. Capital Gains Research Bureau *and the Investment Advisers Act of 1940*, 91 B.U. L. REV. 1051, 1081–82 (2011).

342. Investment Company Act of 1940, 15 U.S.C. § 80a (2000).

343. *See In re* Putnam Inv. Mgmt. LLC, Investment Company Act, S.E.C. Release No. 2192, Administrative Proceeding File No. 3-11317, 2003 WL 22683975, at *6 (Nov. 13, 2003) ("[W]hile acting as an investment advisor, [Putnam] employed devices, schemes, or artifices to defraud clients or prospective clients . . . .").

dealing securities trading—using non-pubic information to engage in market-timing—by several of its employees to investors in the mutual funds.[344] The Commission further found that Putnam failed to detect and deter such trading activity through internal controls and failed to supervise its investment management professionals.[345] Putnam consented to the entry of the Commission's order without admitting or denying its findings and agreed not to contest the SEC's findings.[346] It ultimately paid $55 million to settle the SEC claims.[347]

More importantly, for purposes of this Article, the SEC demanded, and Putnam agreed to, a series of wide-ranging corporate governance reforms.[348] Putnam agreed to enhance the independence of its board, enhance shareholder voting power and disclosures, and supply support staff to board members to assist in their monitoring duties.[349] The firm also agreed to make certain enhancements to its compliance including the creation of a reporting obligation from the firm's chief compliance officer to the board, the creation of new committees for ethics and compliance, and the periodic retention of an independent consultant to review compliance policies and procedures.[350] Thus, like the federal bank

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344. *In re* Putnam Investments LLC, Administrative Proceeding No. 3-11317, SEC. EXCH. COMM'N (Nov. 13, 2003), https://www.sec.gov/litigation/admin/ia-2192.htm (last visited Dec. 15, 2016) (on file with the Washington and Lee Law Review).

345. *Id.*

346. *Id.*

347. *See Putnam Agrees to Pay $55 Million to Resolve SEC Enforcement Action Related to Market Timing by Portfolio Managers*, SECURITIES & EXCHANGE COMMISSION (Apr. 8, 2004), https://www.sec.gov/news/press/2004-49.htm (last visited Dec. 15, 2016) (announcing Putnam's agreement to pay a fifty-million dollar penalty and five-million dollar disgorgement) (on file with the Washington and Lee Law Review).

348. *See id.* ("Putnam agreed to undertake significant and far-reaching corporate governance, compliance, and ethics reforms.")

349. *See Putnam Agrees to Make Restitution and Implement Immediate, Significant Structural Reforms in Partial Resolution of SEC Enforcement Action*, SEC. & EXCH. COMM'N (Nov. 13, 2003), https://www.sec.gov/news/ press/2003-156.htm (last visited Dec. 15, 2016) (describing Putnam's reforms as an effort to make "real and substantial" reforms in order to better protect mutual fund investors) (on file with the Washington and Lee Law Review).

350. *See id.* (enumerating the various areas of compliance Putnam agreed to reform as a result of the SEC's order).

regulators, the SEC routinely exercises its regulatory power to achieve superior compliance, risk management, and corporate governance in wayward registrants and regulated entities.[351]

The federal financial regulators, however, segregated the issue of diversity to the extreme margins of their respective regulatory activities, examinations, and regulatory processes. As previously mentioned, the Dodd–Frank Act directs the federal financial regulators to promulgate standards for "assessing the diversity policies" of regulated entities, and the regulators turned away from the plain meaning of the statute to create a "self-assessment."[352] Congress could not have meant "self-assessment," otherwise there would be no need for the statutory language in Section 342(b)(4) of the Dodd–Frank Act, stating that the assessment could not alone be used for any mandate regarding "lending policies" or "to require any specific action based on the findings of the assessment."[353] This provision is meaningless and redundant in the context of self-assessments.[354] Worse, the federal financial regulators state within the Joint Guidelines that "[t]he agencies will not use their examination or supervisory processes in connection with these Standards."[355] Further, the agencies state that the Joint Guidelines do not "create any new legal obligation."[356] It is as if Congress simply directed the agencies to promulgate voluntary guidelines for regulated entities to undertake self-assessments of optional diversity policies.

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351. *See, e.g.*, *supra* notes 343–350 and accompanying text (outlining the SEC's enforcement action against Putnam).

352. *Compare* Dodd–Frank Act § 342(b)(2)(C), 12 U.S.C. § 5452(b)(2)(C) (2012) (requiring the federal financial regulators to create standards for "assessing the diversity policies and practices of entities regulated by the agency"), *with* Joint Guidelines, *supra* note 44, at 33024 ("[T]he agencies interpret the term 'assessment' to mean self-assessment."). Congress did not use the term "self-assessment." 12 U.S.C. § 5452(b)(2)(C) (2012).

353. Dodd–Frank Act § 342(b)(4), 12 U.S.C. § 5452(b)(4).

354. In general, statutes should be construed in a way that avoids rendering any provision meaningless or surplus. This interpretation "flouts the rule that a statute should be construed so that effect is given to all its provisions, [and] no part will be inoperative or superfluous." Clark v. Rameker, 134 S. Ct. 2242, 2248 (2014) (internal quotations omitted).

355. Joint Guidelines, *supra* note 44, at 33.

356. *Id.*

We suggest an alternative to breathe life into Section 342 in accordance with the plain meaning of Section 342. In accordance with the preexisting powers held by the federal financial regulators (discussed above),[357] federal financial regulators should use their examination and supervisory powers to assess the diversity policies of regulated entities under the standards promulgated in the Joint Guidelines.[358] Then, if those policies are sufficiently deficient that they form a basis—combined with all other facts and deficiencies found by the regulators—for adverse comments in examination reports, then such deficiencies should be treated as any other regulatory issue.[359] Finally, in seeking to enhance risk management, legal and regulatory compliance, as well as ethicality, the regulators should require more aggressive efforts at diversification at miscreant firms that violate laws and regulations related to those areas. This approach effectively vindicates the act of Congress.

It also vindicates the essential purpose of the Dodd–Frank Act overall. Based upon the empirical evidence developed in Part III of this Article, diversity is essential to appropriate risk management, particularly compliance and ethics risk management. Consequently, sound diversity management vindicates macroprudential regulation, macroeconomic stability and growth, and the essential publicness of the financial sector. In sum, our

357. *See supra* notes 322–325 and accompanying text (analyzing the power of federal regulators in depth).

358. This would encourage but not mandate diversity policies. The courts themselves already encourage such policies in every firm subject to Title VII. *See* Burlington Indus. v. Ellerth, 524 U.S. 742, 744–46 (1998) (articulating defense for Title VII vicarious liability for firms with appropriate policies); Faragher v. City of Boca Raton, 524 U.S. 775, 808 (1998) (holding as a matter of law that the City of Boca Raton could not establish the defense because it had failed to disseminate the policy to all of its employees, and its policy failed to include a provision allowing the complaining person to bypass the harassing supervisor); Allen v. Mich. Dep't. of Corr., 165 F.3d 405, 409–12 (6th Cir. 1999) (finding that an African American was the victim of unreasonable abusive and offensive racial harassment and extending the above holdings to the race discrimination context); Steven A. Ramirez, *The New Cultural Diversity and Title VII*, 6 MICH. J. RACE & L. 127, 164–65 (2000) (reviewing case law regarding diversity policies, harassment, and hostile work environment).

359. Implicit in this approach is that diversity policy deficiencies standing alone, with no threat of serious risk of loss, are not a matter of regulatory concern. This fully actualizes Section 342(b)(4).

approach squares the statutory language of Section 342 with the essential purposes of Dodd–Frank and the best learning extant on the potential of cultural diversity.

VII. Conclusion

Congress correctly identified a major blind spot on Wall Street—a culturally homogenous elite prone to herd behavior, groupthink, and affinity bias.[360] These maladies exacted a heavy cost upon the rest of the nation in the context of the financial crisis, which was marked by a mindless real estate bubble, dubious ethics, outright violations of laws and regulations, and the worst risk mismanagement in our nation's history. There is no certainty that a more culturally diverse financial sector would have entirely prevented the crisis or dramatically lessened its effects. Embracing the full spectrum of cultural diversity allows firms to access and balance the full spectrum of perspectives and experiences that support superior cognition, especially with respect to risk, ethics, and compliance.

Nevertheless, empirical studies strongly suggest that a more culturally diverse financial sector could have reduced subprime lending, limited the extent of the real estate bubble, limited the essential lawlessness of the financial sector, and enhanced ethical decision making.[361] These empirical studies are either based upon actual learning from the financial crisis or sophisticated experiments simulating market behavior.[362] While omitted variables can never be ruled out and disentangling causation from mere correlation is always challenging, the studies carefully control for many factors and boast careful designs expressly to

360. *See supra* notes 49–51 and accompanying text (exploring the difficulties and ramifications of group think and herd behavior in financial institutions).

361. *See supra* note 56 and accompanying text (reviewing multiple studies that point to correlation between increased gender diversity and positive business outcomes).

362. *See supra* notes 56–59 and accompanying text (summarizing multiple studies that illustrate the difference between diverse and non-diverse governance results, as well as differences in perception between white males and people of other backgrounds).

limit such concerns.[363] In all events, a thoroughgoing embrace of cultural diversity will certainly yield superior social and economic outcomes relative to the financial crisis yielded by culturally monolithic financial firms. Viewed from the perspective of that crisis in capitalism, it is impossible for cultural diversity to fail.

Consequently, we suggest that the financial regulators modify the basic approach of the Joint Guidelines and fully integrate them into all aspects of their examination and supervisory processes. Further, firms should face legal obligations with respect to diversity to the extent that mismanagement of diversity contributes to unsafe and unsound practices or creates an environment and culture of unlawful conduct. The regulators should also proactively require stronger diversity measures for firms sanctioned for unlawful behavior or risk mismanagement as part of negotiated enforcement outcomes.

This more robust approach to Congress's directive with respect to diversity is far more consistent with the plain meaning of Section 342. It also fully vindicates the macroeconomic, macroprudential, and publicness concerns that animate the Dodd–Frank Act. A more diverse financial sector is bound to allocate capital better, achieve greater systemic stability, and meet the public's expectations of the financial sector.

363. *See supra* note 56 ("After controlling for size, industry, and other corporate governance measures, we find statistically significant positive relationships between the presence of women or minorities on the board and firm value . . . .").