

Regulation by Settlement

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Abstract

This article explores a recent development at the intersection of administrative law and financial regulation: the explosion in enforcement actions brought by federal agencies against financial institutions, and the exclusive resolution of those cases via settlement agreements that preclude meaningful judicial review. It argues that those practices have given rise to a distinct new form of policymaking, “regulation by settlement,” which has significant implications for both areas of the law.

Regulation by settlement has two defining features. First, by pursuing settlements that target certain areas of the financial system on a comprehensive basis, agencies are able to leverage those agreements in a manner that effectively establishes novel legal standards of general applicability. Settlements are now a tool for setting policy in financial regulation. Second, the procedural posture of those settlements allows agencies to engage in a uniquely freewheeling style of policymaking, which sidesteps nearly all of the constraints that administrative law applies to more conventional forms of agency action.

The article closes by considering normative issues raised by regulation by settlement, including questions concerning its consistency with rule of law values and efficiency from a cost-benefit perspective. It also reviews potential reforms, such as subjecting settlements to greater judicial scrutiny or presidential oversight. The broader contribution to the literature is to show how a richer understanding of the regulatory process can be gained by analyzing its public law and business law aspects in parallel.

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I. Introduction

Despite its institutional sprawl and legal complexity, the modern administrative state is commonly understood to reflect a single, central balancing act. On the one hand, agencies are granted vast policymaking discretion in deference to their superior subject matter expertise. On the other hand, that delegation is simultaneously cabined by a thicket of procedural constraints, intended to serve as safeguards against arbitrary or opportunistic decision-making.¹ The end product is regulation that emerges from a “very elaborate, inclusive, deliberate, multi-staged, heavily lawyered decision-making process.”² Rather than rehash the merits of this standard model, public law scholarship increasingly seeks to uncover pockets of administrative “unorthodoxy,” where the typical checks on agency action fall away.³ A classic example concerns executive inaction, where the President’s judgment to

¹ See generally Lisa Bressman, *Procedure as Politics in Administrative Law*, 107 COLUM. L. REV. 1749 (2007); Richard B. Stewart, *The Reform of American Administrative Law*, 88 HARV. L. REV. 1667 (1974).

² Thomas W. Merrill, *A Comment on Metzger and Zaring: The Quicksilver Problem*, 78 L. & CONTEMP. PROBS. 189 (2015).

³ See Abbe R. Gluck, Anne Joseph O’Connell & Rosa Po, *Unorthodox Lawmaking, Unorthodox Rulemaking*, 115 COLUMB. L. REV. 1791 (2015); Daniel A. Farber & Anne Joseph O’Connell, *The Lost World of Administrative Law*, 92 TEX. L. REV. 1138 (2014).

not enforce the law cannot be second-guessed by other political actors.⁴ Another paradigm case involves regulation during periods of emergency, which tend to empower agencies to seize the policy agenda in a relatively unfettered manner.⁵ The recent financial crisis proved fertile ground for emergency regulation and, according to one influential account, freed agencies to adopt highly informal crisis management tactics that amounted to a regime of “regulation by deal.”⁶

While emergency interventions such as regulation by deal are by definition temporary, this article identifies a new form of administrative unorthodoxy—“regulation by settlement”—that is reshaping the day-to-day status quo of financial regulation and may be here to stay. Regulation by settlement refers to a practice that has emerged from recent changes in the regulatory enforcement environment, which include an increased emphasis on corporate (rather than individual) liability, skyrocketing monetary penalties, and the nearly exclusive imposition of those penalties via innovative legal instruments that facilitate out-of-court settlement. Regulation by settlement has two defining features. First, although regulatory settlements are nominally packaged in the form of particularized adversarial disputes, agencies now leverage those agreements in a manner that effectively establishes new legal standards of general applicability. They are a tool for setting policy. Second, the procedural posture of those settlements allows agencies to engage in a uniquely freewheeling mode of regulation, which sidesteps nearly all of the legal constraints that are familiar to the standard administrative model.

To make these conceptual points more concrete, this article presents three case studies that illustrate how regulation by settlement operates in practice.⁷ In each case, the basic pattern is a series of settlements that are negotiated in rapid succession, involve fines reaching into the billions of dollars, and target certain areas of the financial system on a comprehensive basis. Imposing penalties on such a scale carries a precedential effect that allows agencies to establish general rules-of-the-

⁴ See Jeffrey A. Love & Arpit K. Garg, *Presidential Inaction and the Separation of Powers*, 112 MICH. L. REV. 1195, 1197-99 (2014); Daniel T. Deacon, *Deregulation Through Nonenforcement*, 85 N.Y.U. L. REV. 795 (2010); Lisa Schultz Bressman, *Judicial Review of Agency Inaction: An Arbitrariness Approach*, 79 N.Y.U. L. REV. 1657 (2004).

⁵ See Eric A. Posner & Adrian Vermeule, *THE EXECUTIVE UNBOUND: AFTER THE MADISONIAN REPUBLIC* (2011); Adrian Vermeule, *Our Schmittian Administrative Law*, 122 HARV. L. REV. 1095 (2009).

⁶ Steven M. Davidoff & David Zaring, *Regulation by Deal: The Government’s Response to the Financial Crisis*, 61 ADMIN. L. REV. 463, 536 (2009) (explaining that Regulation by deal “reject[ed] some of the usual values of administrative law, such as predecision notice to affected parties and the public; measured, unhasty action; and comment-ventilated policymaking.”); see also Eric A. Posner & Adrian Vermeule, *Crisis Governance in the Administrative State: 9/11 and the Financial Meltdown of 2008*, 78 U. CHI. L. REV. 1613 (2010); cf. Steven Davidoff Solomon & David T. Zaring, *The Dealmaking State: Executive Power in the Trump Administration*, UC Berkeley Public Law Research Ppr. No. 2921407 (Feb. 2017).

⁷ See Section II.B (covering the “FCPA Settlements,” the “Securitization Settlements,” and the “Benchmark Manipulation Settlements”); see also Section II.C (noting a number of further examples).

road going forward.⁸ Importantly, those rules redefine the contours of substantive policy because the settlements at issue do not closely track pre-established legal obligations. Instead, they tend to be premised on novel theories of liability that involve aggressive statutory interpretation or otherwise draw on background legal materials in a creative fashion.⁹ In the process, federal agencies have wielded regulatory settlements in a way that reshapes the governance of the financial system to a degree that goes far beyond traditional notions of prosecutorial discretion.

The informality of regulation by settlement enables agencies to dictate policy unencumbered from the legal constraints that apply to notice-and-comment rulemaking, which is the “dominant procedural vehicle for agency lawmaking.”¹⁰ When engaging in rulemaking, agencies must follow protocols set out by the Administrative Procedure Act (APA), which subject their policy judgments to extensive public scrutiny before being finalized.¹¹ In stark contrast, the negotiation of agency settlements is a confidential affair, concluded with a handshake in Washington conference rooms.¹² Regulatory settlements are also immune from most forms of centralized executive branch review, including cost-benefit analysis requirements and other rigors that have become synonymous with “Presidential Administration.”¹³ Finally, once promulgated, administrative rules may be scrutinized pursuant to the “hard look” standard applied by federal courts. The bargains struck in regulatory settlements, meanwhile, are memorialized with out-of-court legal instruments that are susceptible to little or no judicial review.

Here, administrative law specialists will interject with the *Chenery* principle, which holds that agencies have discretion to conduct policymaking through any procedural vehicle available, including adjudicative hearings and informal

⁸ Of course, the “regulation” that results is implicit and does not have the force of law in any traditional or technical sense. But that is of limited real world significance to the market actors that act in its shadow, who as a practical matter must adopt the realist position that “the law is what regulators will do.” Oliver Wendell Holmes, Jr., *The Path of the Law*, 10 HARV. L. REV. 460, 461 (1897) (“The prophecies of what the courts will do in fact, and nothing more pretentious, are what I mean by the law.”).

⁹ Regulation by settlement is therefore distinct from related analyses that focus on the influence that remedial terms in DoJ settlement agreements have on corporate compliance procedures. See Jennifer Arlen & Marcel Kahan, *Corporate Governance Through Non-Prosecution* (2016); Lawrence A. Cunningham, *Deferred Prosecutions and Corporate Governance: An Integrated Approach to Investigation and Reform*, 65 FLA. L. REV. (2013); Brandon L. Garrett, *Structural Reform Prosecution*, 93 VA. L. REV. 853 (2007).

¹⁰ Richard B. Stewart, *Administrative Law in the Twentieth Century*, 78 N.Y.U. L. REV. 437, 444 (2003). The prominent role of notice-and-comment rulemaking is especially evident in financial regulation, where it is cornerstone of the Dodd Frank Act. DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT OF 2010, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [*hereinafter* Dodd-Frank].

¹¹ See Administrative Procedure Act of June 11, 1946, Pub. L. No. 79-404, 60 Stat. 237 (codified as amended in scattered sections of 5 U.S.C.) (1946) [*hereinafter* APA].

¹² Stewart, *supra* note 1, at 1687 (observing that “the quiet settlement of litigation once initiated – take[s] place through informal procedures where the traditional controls have not normally applied.”).

¹³ See Elena Kagan, *Presidential Administration*, 114 HARV. L. REV. 2245 (2001); Lawrence Lessig & Cass R. Sunstein, *The President and the Administration*, 94 COLUM. L. REV. 1, 102-03 (1994).

statements such as guidance documents.¹⁴ Securities law experts will likewise point to the SEC’s alleged use of “regulation by enforcement” to develop insider trading law.¹⁵ The most striking quality of regulation by settlement, however, is that it allows agencies to avert two pervasive tradeoffs that accompany the decision to switch from notice-and-comment rulemaking to take advantage of less formal policymaking venues. The first is a “formality-review” tradeoff, in which agencies tend to receive more deferential judicial review in exchange for adopting more formal procedures.¹⁶ Agencies face a “substance-discretion” tradeoff as well. In general, regulators must invest in greater procedural formality when making decisions that push the substantive boundaries of policy in bolder directions.¹⁷ Yet unlike most other informal modes of agency action, regulation by settlement simultaneously circumvents both tradeoffs, by combining aggressive substantive policymaking with maximal procedural laxness and minimal ex post review.

Although the primary purpose of this article is to present a positive analysis of regulation by settlement, it closes by considering normative issues as well as potential policy reforms. The rise of regulatory settlements has been viewed as in tension with traditional rule of law values. As will be argued, however, many of these concerns are misplaced.¹⁸ From a less legalistic and more consequentialist perspective, it is clear that regulation by settlement carries costs as well as benefits. Its primary benefit is to invest agencies with greater flexibility, by allowing regulators to police corporate misconduct in a way that keeps pace with evolving market conditions and the strategic adaptations of firms. At the same time, reliance on settlements necessarily injects ambiguity into the legal standards that govern market activity, and may also encourage agencies to intervene in regulated industries in an uncoordinated or otherwise overly aggressive manner. As the case studies show, the weight of these costs-and-benefits does not uniformly cut in one direction, and depends on the legal and economic context in which regulation by settlement is applied. A policy upshot is that any reform to agencies’ enforcement practices should be incremental and work at the margin. While the main proposals in this area advocate for enhanced judicial scrutiny of regulatory settlements, this article

¹⁴ *SEC v. Chenery Corp.*, 332 U.S. 194 (1947) (*Chenery II*).

¹⁵ See Harvey L. Pitt & Karen L. Shapiro, *Securities Regulation by Enforcement: A Look Ahead at the Next Decade*, 7 *YALE J. REG.* 149, 149 (1990).

¹⁶ See *United States v. Mead Corp.*, 533 U.S. 218 (2001); Cass R. Sunstein, *Chevron Step Zero*, 92 *VA. L. REV.* 187 (2006); M. Elizabeth Magill, *Agency Choice of Policymaking Form*, 71 *U. CHI. L. REV.* 1383 (2004).

¹⁷ See Matthew C. Stephenson, *The Strategic Substitution Effect: Textual Plausibility, Procedural Formality, and Judicial Review of Agency Statutory Interpretations*, 120 *HARV. L. REV.* 528 (2006).

¹⁸ For one, there is nothing inherently suspect about resolving disputes through settlement, which economizes on government resources and supplies the private goods of finality and repose. In addition, the frequent claims that agencies violate separation of powers commitments by pursuing policymaking through informal channels (including enforcement actions) neglect the fact that the combination of governmental functions is a hallmark of the administrative state. See Section IV.A, *infra*.

explains that a more promising approach would be to facilitate greater oversight of settlements within the executive hierarchy itself.¹⁹

The broader contribution of this article is to supply a richer account of the regulatory process by examining its public law and business law aspects in parallel. Although administrative law and financial regulation overlap along prominent historical and institutional dimensions, legal scholarship has displayed a puzzling tendency to consider each in isolation.²⁰ Thus, as one commentator has observed, the time is “ripe for sustained and reciprocal engagement between administrative law and financial regulation at both a conceptual and more granular level.”²¹ This article takes up both challenges. It first proceeds by adopting a fine-grained look at the evolving procedural features of agency enforcement practices, and explains the overlooked ways they have come to influence the substance of financial regulation. It then uses those same developments in financial regulation as a lens to uncover a new and qualitatively distinct mode of regulatory policymaking, thereby advancing the administrative law literature on agency unorthodoxy.

The organization of this article is as follows. Section II approaches regulation by settlement from a business law perspective that analyzes its growing role in the governance of the financial system. Section III turns to the public law implications of regulation by settlement, and explains how it represents a novel mode of unorthodox administrative lawmaking. Section IV considers normative issues and then reviews potential policy reforms. Section V briefly concludes.

II. Regulation by Settlement & the Financial System

This section explains how federal agencies have reshaped the content of post-crisis financial regulation by settling enforcement actions against firms. Part A identifies key changes in the regulatory landscape that were preconditions for that process to emerge. Part B presents three case studies that illustrate how settlements are used to set policy in practice. Part C briefly notes further examples and provides a summary.

A. The Rise of Regulatory Settlements

Regulation by settlement has been made possible by a sweeping transformation in the enforcement practices of administrative agencies responsible for financial regulation and related areas of securities law. The origins of the new enforcement environment can be traced to changes that began in the early 2000s, and have developed along four, interrelated fronts. First, where enforcement actions against individuals were once the standard, actions against firms have become the norm. Second, disputes between agencies and firms are now almost exclusively

¹⁹ See Section IV.B, *infra* (identifying administrative mechanisms established under the Dodd-Frank Act that could be made responsible for new oversight procedures).

²⁰ See Robert Ahdieh, *Notes from the Border: Writing Across the Administrative Law/Financial Regulation Divide*, 66 J. L. EDUC. 64 (2016); Gillian E. Metzger, *The Evolving Relationship Between Financial Regulation and Administrative Law*, 78 L. & CONTEMP. PROB. 129, 129 (2016).

²¹ Metzger, *supra* note 20, at 131.

resolved via settlement agreements, rather than adjudication on the merits. Third, the nature of settlements has evolved, due to innovative legal instruments which limit judicial review while also facilitating regulator-firm bargains that incorporate a broader set of terms. Fourth, enforcement actions have resulted in dramatically higher monetary penalties.

Regulatory enforcement efforts directed at malfeasance in financial markets has traditionally targeted individuals rather than firms. A paradigm case is enforcement of insider trading by the SEC, which began in the 1960s and has always overwhelming consisted of actions against individuals.²² In banking regulation, the 1980s savings-and-loan crisis resulted in over a thousand criminal convictions of individuals by the DoJ.²³ Likewise, agencies such as the Commodities Futures Trading Commission (CFTC) have tended to use their remedial authority to target market professionals with license revocations and modest fines.²⁴

Corporate liability started to receive greater emphasis with a pair of guidance documents—the DoJ’s Holder Memorandum of 1999 and the SEC’s Seaboard Report of 2001—both of which provided government attorneys with a roadmap for bringing cases specifically against firms.²⁵ The shift in enforcement priorities gained traction shortly thereafter, when the dot.com boom collapsed in a wave of accounting fraud and options back-dating scandals. Although that era yielded hundreds of proceedings against corporate managers, high-profile firms such as Enron and WorldCom were found liable as well.²⁶ Those successes spurred regulators to further prioritize “vigorous enforcement . . . [against] corporate wrongdoers.”²⁷ A full swing of the enforcement pendulum from individual to corporate liability was complete following the financial crisis of 2008. As has been widely documented (and frequently criticized), actions against the high-ranking financial executives who were involved in those events have been nearly non-existent relative to historical standards.²⁸

²² See James J. Park, *Rules, Principles, and the Competition to Enforce the Securities Laws*, 100 CAL. L. REV. 115, 153-54 (2012).

²³ See Bruce A. Green, *After the Fall: The Criminal Law Enforcement Response to the S&L Crisis*, 59 FORDHAM L. REV. S155 (1991) (over 1,000 financial executives convicted of crimes).

²⁴ See Ben Protess, *Libor Case Energizes a Wall Street Watchdog*, N.Y. TIMES DEAL BOOK (Aug. 12, 2012).

²⁵ Eric Holder, FEDERAL PROSECUTION OF CORPORATIONS, U.S. DEP’T OF JUSTICE (June 16, 1999) [*hereinafter* Holder Memorandum]; SEC. & EXCH. COMM’N, COMMISSION STATEMENT ON THE RELATIONSHIP OF COOPERATION TO AGENCY ENFORCEMENT DECISIONS, RELEASE NO. 44969 (Oct. 23, 2001).

²⁶ See Peter Lattman, *Looking at Ken Lay and the Lack of Financial Crisis Cases*, N.Y. TIMES (JULY 5, 2011) (reporting that dot.com era enforcement resulted in 1,300 corporate fraud convictions, including cases against more than 200 high-ranking executives); Stephen J. Choi, Anat Carmy Wiechman & Adam C. Pritchard, *Scandal Enforcement at the SEC: The Arc of the Option Backdating Investigations*, AM. L. & ECON. REV. (2013).

²⁷ MEMORANDUM FROM LARRY D. THOMPSON, DEP. ATT’Y GEN., U.S. DEP’T. OF JUSTICE, PRINCIPLES OF FEDERAL PROSECUTION OF BUSINESS ORGANIZATIONS (Jan. 20, 2003) [*hereinafter* Thompson Memorandum].

²⁸ See David Zaring, *Litigating the Financial Crisis*, 100 VA. L. REV. 1405, 1410-11 (2014) (noting the “surprising dearth of individual penalties” coming out of the financial crisis);

While settlement of regulatory actions has always been commonplace, it became a predetermined outcome following the dot-com era enforcements. The proximate cause was a jury trial of Enron’s auditor, the accounting firm Arthur Andersen, which ended in a criminal conviction that immediately drove the company into bankruptcy. The Arthur Andersen episode gave rise to the perception that findings of criminal liability amounted to a “corporate death penalty,” due to the costly collateral consequences that firms could expect to encounter as a result.²⁹ Risk-averse firms reacted by becoming even more avoidant of bet-the-company litigations, regardless of the underlying merits.³⁰ The government also expressed unease with the Arthur Andersen episodes, and acknowledged the unfairness that corporate penalties carried for otherwise innocent shareholders and employees.³¹ Thus, the demand for settlement increased for all parties involved.

Supply rose to meet demand once the DoJ began to offer firms the option of resolving enforcement actions pursuant to previously esoteric legal instruments—known as deferred prosecution agreements (DPAs) and non-prosecution agreements (NPAs) (collectively, pretrial diversion agreements PDAs).³² Those agreements had innovative features that made settlement even more attractive for both sides. Firms benefited from PDAs because they allow defendants to not only escape trial, but also avoid the collateral consequences associated with admissions of wrongdoing, which are by definition required in traditional guilty pleas.³³ Because they are subject to little or no judicial review, PDAs provided the government with a valuable new low-risk, low-cost dispute resolution vehicle.³⁴ The DoJ also took advantage of the informal, out-of-court nature of PDAs to introduce novel settlement terms—which require firms to reform internal compliance procedures and to install corporate “monitors” who are authorized to supervise the performance of those initiatives—

see also; Jed S. Rakoff, *The Financial Crisis: Why Have No High-Level Executives Been Prosecuted?*, N.Y. REV. OF BOOKS (Jan. 9, 2014); N.Y. TIMES, *Financial Crises Compared: The Savings and Loan Debacle and the Mortgage Mess*, (Apr. 13, 2013).

²⁹ Collateral consequences include reputational harm in the marketplace, bans on eligibility for government contracting, and follow-on shareholder class actions. *See* Cunningham, *supra* note 9.

³⁰ Arthur Andersen was ruined despite ultimately prevailing on the merits. Four years after the firm’s bankruptcy, a 9-0 Supreme Court decision vacated its conviction on all counts. *Arthur Andersen LLP v. United States* (2005); *cf.* Gabriel Markoff, *Arthur Andersen and the Myth of the Corporate Death Penalty*, 15 U. PA. J. BUS. L. 797 (2013).

³¹ *See* THOMPSON MEMORANDUM, *supra* note 27 (stating this concern); *see also* Lanny A. Breuer, Speech at the New York City Bar Ass’n (Sept. 13, 2013); Matthew E. Fishbein, *Why Individuals Aren’t Prosecuted for Conduct Companies Admit*, N.Y. L. J. (Sept. 19, 2014).

³² With a DPA, a prosecutor files a criminal charge (or criminal information) in court but agrees to defer any actual prosecution if the defendant satisfies certain terms-and-conditions. Under an NPA, a prosecutor agrees not to file a charging document at all in return for a firm’s commitment to certain conditions. NPAs are therefore memorialized in the form of a letter, rather than a court document. Brandon L. Garrett, *supra* note 9 at 928.

³³ The “Filip Memorandum” of 2008 provides a relatively unconditional embrace of reliance on PDAs. *See* MEMORANDUM FROM MARK FILIP, DEP. ATT’Y GEN., U.S. DEP’T OF JUSTICE (Aug. 29, 2008).

³⁴ *See* Section III.B.i, *supra* (reviewing the caselaw on judicial review of PDAs).

that made detection and punishment of recidivism a foregone conclusion.³⁵ Lastly, for the very reason that firms preferred PDAs to guilty pleas, they gave the government leverage to extract larger penalties.³⁶

The DoJ almost never offered pretrial diversion agreements prior to 2003, but their use has since exploded and PDAs now represent the DoJ's primary legal mechanism for concluding actions against high-profile corporate defendants.³⁷ The novel legal format of settlement agreements has not been limited to criminal enforcement. During the same post-2003 period, the SEC has adapted its use of civil settlement instruments, such as cease-and-desist orders, to mimic the out-of-court posture, enhanced monetary penalties, and broad remedial terms of PDAs.³⁸ After the financial crisis, the same basic settlement procedures have been adopted with equal vigor by the full gamut of federal financial agencies.³⁹

The new breed of corporate settlements has been associated with dollar penalties that would have been unfathomable in previous enforcement eras. Over the first dozen years of their existence, PDAs have been associated with total monetary penalties of over \$40 billion.⁴⁰ Corporate penalties imposed by the DoJ—the majority of which are now paid by financial institutions—reached record levels for ten consecutive years, culminating with \$23 billion paid in 2015.⁴¹ A \$550 million settlement between the SEC and Goldman Sachs in 2010 was hailed at the time as

³⁵ See Cunningham, *supra* note 9, at 11-15.

³⁶ See *id.*

³⁷ Before 2003, the DoJ had entered into less than 30 DPAs. Since then, however, it has concluded over 300. The use of NPAs has followed a parallel trajectory. Cunningham, *supra* note 9, at 14; GIBSON DUNN, 2015 YEAR END UPDATE ON CORPORATE NON-PROSECUTION AGREEMENTS (NPAs) AND DEFERRED PROSECUTION AGREEMENTS (DPAs) (Jan. 5, 2016); see also Brandon Garret & David Zaring, *For a Better Way to Prosecute Corporations, Look Overseas*, N.Y. TIMES DEALBOOK (Sept. 23, 2013) (noting over 60% of DPAs are with public corporations, and over 33% involve Fortune 500 companies).

³⁸ Like DPAs, the SEC files civil settlements in federal court on the same day that it enters a complaint, and thereby preempt litigation on the merits. Since 2010, the SEC has begun to follow the DoJ by employing DPAs and NPAs itself. SEC. & EXCH. COMM'N, PRESS RELEASE, SEC ANNOUNCES INITIATIVE TO ENCOURAGE INDIVIDUALS AND COMPANIES TO COOPERATE AND ASSIST IN INVESTIGATIONS (Jan. 13, 2010). The SEC has also made an end-run around its relatively modest civil fining authority, by relying on equitable remedies, such as disgorgement, which can exceed standard monetary penalties by multiple orders of magnitude. See Paul S. Atkins & Bradley J. Bondi, *Evaluating the Mission: A Critical Review of the History and Evolution of the SEC Enforcement Program*, 13 FORD. J. CORP. & FIN. L. 367, 399 (2008) (arguing that the SEC has shifted to a "punitive" enforcement model during its current "era of increasing penalties against shareholders").

³⁹ See Wachtell Lipton, White Collar and Regulatory Enforcement Trends in 2014 (Jan. 28, 2014) ("Other government regulators also continue to be active in the civil enforcement areas. In addition to the SEC, which has long made aggressive use of its civil enforcement power, other agencies such as the CFTC, the newly-formed CFPB and bank regulators, such as the OCC and the Federal Reserve, have become much more aggressive in seeking civil enforcement remedies and penalties.").

⁴⁰ See GIBSON DUNN, *supra* note 37.

⁴¹ The 2015 total represents a 2,300% increase over the relevant 2001 figure. See Brandon Garrett, *The Rise of Bank Prosecutions*, YALE L. J. FORUM, at 35 (May 23, 2016).

the “largest-ever penalty paid by a Wall Street firm.”⁴² But within two years, that record was beaten by a factor of thirty-two when Bank of America entered into a multi-agency settlements for \$16.6 billion.⁴³ These trends are not attributable to a few outlier agencies. Financial regulators that have a prior track record of extracting significant corporate fines—such as the Federal Reserve Board, Office of the Comptroller of Currency (OCC) or CFTC—now regularly impose penalties that reach into the billions per year.⁴⁴

Each of the developments summarized above have been noted in the business law literature, but typically in a piecemeal fashion that focuses on particular agencies, settlement instruments, or legal prohibitions. Such an approach obscures the striking fact that all four trends have taken place on a roughly contemporaneous basis, across every agency with jurisdiction over financial institutions, and in the context of both criminal and civil corporate liability. To a large extent, regulators at the OCC now wield settlement instruments such as consent orders in a manner that is functionally indistinguishable from the use of DPAs by DoJ prosecutors.⁴⁵ An implication is that there has been a reorientation of the relationship between the financial system and the administrative state as a whole, with regulatory settlements now occupying a central role. As a result, agencies are able to leverage those agreements in a manner that reshapes policy to a degree that goes far beyond traditional notions of prosecutorial discretion or “regulation by enforcement.”⁴⁶

B. Three Case Studies

The following three case studies illustrate how regulation by settlement works in practice. The first case involves enforcement of anti-corruption

⁴² Sec. & Exch. Comm’n, *Goldman Sachs to Pay Record \$550 Million to Settle SEC Charges Related to Subprime Mortgage CDO*, Litig. Release No. 21592 (July 15, 2010). Compare a 2002 settlement with Xerox, in which the SEC obtained its first \$10 million enforcement penalty against a securities issuer. Atkins & Bondi, *supra* note 38, at 399.

⁴³ All told, regulatory enforcement actions against banks for securitization practices has been estimated to have resulted in \$110 billion in penalties. Christina Rexrod & Emily Glazer, *Big Banks Paid \$110 Billion in Mortgage Related Fines*, WALL ST. J. (Mar. 9, 2016).

⁴⁴ In 2014 alone, enforcement actions by the CFTC reportedly resulted in \$3.14 billion in civil penalties. CFTC ANNUAL ENFORCEMENT RESULTS, FISCAL YEAR 2015 PRESS RELEASE (Nov. 6, 2015). Although some commentators argue that agencies are inflating these figures, no amount of rounding up alters the picture of a massive rise in the severity of penalties over recent years. See Urska Velikonja, *Reporting Agency Performance: Behind the SEC’s Enforcement Statistics*, 101 CORNELL L. REV. __ (forthcoming 2016).

⁴⁵ See Section II.B.ii (analyzing the parallel application of those agreements to the same underlying conduct). Legal scholarship has at times sketched a rough analogy between criminal prosecution and administrative enforcement; but as the case studies below will show, regulation by settlement goes much further and completely collapses any meaningful distinction between “white collar crime” and regulatory enforcement. See, e.g., Rachel Barkow, *Institutional Design and the Policing of Prosecutors: Lessons from Administrative Law*, 61 STANFORD L. REV. 869 (2009) (drawing on the administrative law-prosecution analogy); Gerard E. Lynch, *The Role of Criminal Law in Policing Corporate Misconduct*, 60 L. & CONTEMP. PROBS. 23 (1997) (same); Dan Kahan, *Is Chevron Relevant to Federal Criminal Law?*, 110 HARV. L. REV. 469, 470 (1996).

⁴⁶ See Section III.B.iii, *infra* (comparing regulation by settlement to previous forms of administrative enforcement).

prohibitions in securities law pursuant to the Foreign Corrupt Practices Act (FCPA). Although the FCPA Settlements do not concern “financial regulation” narrowly understood, they are an important precursor and blueprint for agency practices that have subsequently been applied more broadly in financial regulation. The second case study looks at settlements arising from agency actions against the issuance of mortgage-backed securities by large banks that were at the heart of the financial crisis (the Securitization Settlements). The Securitization Settlements reveal that a major component of post-financial crisis regulation has been dictated informally through settlements, rather than the regime installed under the Dodd-Frank Act. The third case examines a line of settlements in connection with financial benchmarks such as the Libor index (the Benchmark Settlements). The Benchmark Settlements provide a case in which regulation by settlement has been applied to critical areas of the financial sector which were not directly related to the financial crisis.

i. *The FCPA Settlements*

Congress passed the FCPA in 1977,⁴⁷ in response to a series of corporate corruption scandals that were uncovered by investigations into the Watergate scandal.⁴⁸ The core of the statute is its “anti-bribery provisions,” which prohibit entities or individuals from making improper payments to foreign governments in order to gain a business advantage.⁴⁹ In addition, the FCPA has “books-and-records” and “internal controls” provisions, which require that corporate accounting procedures are reasonably designed to detect or deter potentially illicit payments.⁵⁰ The law is jointly enforced by the DoJ and SEC.⁵¹

The FCPA’s enforcement history is a microcosm of the system-wide enforcement trends reviewed above. From the date of its passage until the early 2000s, the statute was a legal curio that was rarely used.⁵² Since that initial quiet period, however, enforcement efforts at both the DoJ and SEC have rapidly accelerated.⁵³ The rise of FCPA enforcement has paralleled the broader shift in focus from individual to corporate liability. It also tracks the turn toward settlement as the exclusive mode of dispute resolution, including the abandonment of traditional guilty pleas in favor of pretrial diversion agreements.⁵⁴ Lastly, the relatively modest

⁴⁷ Foreign Corrupt Practices Act of 1977, 15 U.S.C. §§ 78m, 78dd-1 to -3, 78ff (2011).

⁴⁸ SEC, REPORT OF THE SECURITIES AND EXCHANGE COMMISSION ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES (May 19, 1976).

⁴⁹ 15 U.S.C. § 78dd-1(a).

⁵⁰ *Id.* § 78m(b).

⁵¹ The DoJ has authority to pursue criminal penalties, while the SEC can impose fines and disgorgement of profits in connection with civil liability. *See* U.S. DEP’T OF JUSTICE, THE LAY PERSON’S GUIDE TO THE FOREIGN CORRUPT PRACTICES ACT ANTI-BRIBERY PROVISIONS.

⁵² The DoJ only initiated 24 FCPA actions against corporations for the entire 1977-2004 period. *See generally* Michael B. Bixby, *The Lion Awakens: The Foreign Corrupt Practices Act—1977 to 2010*, 12 SAN DIEGO INT’L L. J. 89 (2010).

⁵³ *See id.*

⁵⁴ *See* Mike Koehler, *Measuring the Impact of Non-Prosecution and Deferred Prosecution Agreements on Foreign Corrupt Practices Act Enforcement*, 49 U.C. DAVIS LAW REVIEW 497 (2015) [hereinafter *Foreign Corrupt Practices Act Enforcement*].

finances which characterized the FCPA's quiet period have given way to a boom-era of skyrocketing penalties that now reach into the billions per year.⁵⁵

What is the legal basis underlying the sudden surge in corporate FCPA liability? A precise answer is surprisingly difficult to pin down by reference to the standard legal sources. Congress expressed core elements of the law with vague language that cries out for further clarification: a bribe consists of an offer to "corruptly" provide "anything of value" to a "foreign official" in order to "obtain or retain business."⁵⁶ There is an available legislative history, but it has been subject to neglect, and reflects a Nixonian, Cold War milieu that is of uncertain applicability to the contemporary global business environment.⁵⁷ Caselaw is of limited help as well. Because the FCPA enforcement boom has been concurrent with the rise of regulatory settlements, federal courts have had minimal opportunities to flesh out the meaning of important yet ambiguous statutory terms.⁵⁸ In fact, only one corporate defendant has ever taken FCPA-related charges to trial, and that was a 1983 case from the FCPA's "pre-modern" era.⁵⁹ The enforcement agencies, for their part, have done little to fill the resulting interpretive void. There is an FCPA "Opinion Procedure," established by statutory amendments in 1988, but it only allows the agencies to respond to hypothetical scenarios that are volunteered by firms, and is rarely utilized.⁶⁰ And, with the exception of a guidance document issued in 2012 (to be discussed below), the only other agency interpretative materials that have been released are a pair of rules issued by the SEC in 1979.⁶¹

Accordingly, when corporate counsel prepare to advise their clients on FCPA liability, they do not linger over the statute, regulatory materials, or judicial opinions. Instead, they consult online databases that summarize prior settlements, and attempt to extract a general rule that will predict future enforcement practices.⁶² Because FCPA settlements have repeatedly centered around particular industries, business practices, or statutory terms, certain implicit legal standards governing anti-

⁵⁵ The DoJ has collected roughly \$3 billion since 2010. *See id.*

⁵⁶ 15 U.S.C. § 78dd-1(a). *See* James R. Doty, *Toward A Reg. FCPA: A Modest Proposal for Change in Administering the Foreign Corrupt Practices Act*, 62 *BUS. LAWYER* 1233 (Aug. 2007) ("vagueness and ambiguity are the DNA of the FCPA").

⁵⁷ *See* Mike Koehler, *The Story of the Foreign Corrupt Practices Act*, 73 *OHIO ST. L. J.* (2012).

⁵⁸ *U.S. v. Kozeny*, 493 F. Supp. 2d 693, 697 (S.D.N.Y. 2007) (noting that there are "surprisingly few decisions throughout the country on the FCPA.").

⁵⁹ *SEC v. World-Wide Coin Investments*, 567 F. Supp. 724 (N.D. Ga. 1983). Since 2004, only two of the DoJ's FCPA actions have even progressed to criminal indictments, and both of those were dismissed. *See* *Lindsey Manufacturing Co.* (Dec. 1, 2011); *Cinergy Telecomm'ns Inc.* (Feb. 24, 2012).

⁶⁰ *See* Matthew W. Muma, *Toward Greater Guidance: Reforming the Definitions of the Foreign Corrupt Practices Act*, 112 *MICH. L. REV.* 1337, 1344 (2014) ("Unfortunately, [Opinion Releases] are scarce, slow in coming, and highly general[.]").

⁶¹ 17 C.F.R. §§ 240.13b2-1, -2.

⁶² *See* Philip Urofsky & Danforth Newcome, *RECENT TRENDS AND PATTERNS IN FCPA ENFORCEMENT*, SHEARMAN & STERLING LLP (Oct. 1, 2009).

corruption law have in fact emerged.⁶³ Notably, the dominant pattern is for those standards to take the pre-existing legal materials in broad and creative directions.

One example is the FCPA's requirement that it must be a "foreign official" who receives the bribe in order for liability to be triggered under the Act.⁶⁴ One possibility—consistent with the circumstances surrounding the FCPA's passage, as well the first two decades of its enforcement—is that such a category is limited to high-ranking government representatives.⁶⁵ But a string of boom-era settlements has established a much more capacious definition. Pursuant to those precedents, the "foreign official" label applies not only to low-ranking bureaucrats, but also covers employees of private companies, such as medical personnel at hospitals, in which the government has a partial (in some case only minority) ownership stake.⁶⁶ Because a good deal of investment takes place in developing economies where the line between private and public sectors is often far from clear, the agencies' "foreign official" interpretation has proven highly consequential.⁶⁷

Another policy question concerns the relevant benefit that a corporation must receive in exchange for its payment to a foreign official. The statutory language requires that a bribe be intended to "obtain and retain business," which, under some readings, might be limited to payments used to rig the bidding in auctions for government procurement contracts.⁶⁸ In contrast, a number of settlements are premised on a broader interpretation that reaches regulatory preferences of all kinds, such as decisions regarding tax treatments or licensing approvals.⁶⁹ Despite the settlements' liberal interpretation of what it means to "obtain and retain business," that definition is potentially cabined by a related statutory safe harbor, known as the "facilitating payments" exception. The facilitating payments exception provides that, regardless of the nature of the benefit received, there is no liability in cases

⁶³ FOREIGN CORRUPT PRACTICES ACT: HEAR'G BEFORE THE SUBCOMM. ON CRIME, TERRORISM, AND HOMELAND SEC. OF THE H. COMM. ON THE JUDICIARY, 112TH CONG. 22 (2011) (statement of Michael Mukasey) ("the primary statutory interpretive function therefore is performed almost exclusively by the DOJ by negotiating resolutions before an indictment or enforcement actions is filed . . . We are left with a circumstance in which 'the FCPA means what the enforcement agencies say it means.'").

⁶⁴ The statute further provides that a "foreign official" may consist of a government "department," "agency," or "instrumentality." 15 U.S.C. § 78dd-1(f).

⁶⁵ See Mike Koehler, *From SOE Employees to Health Care Providers –The "Foreign Officials" of 2012*, FCPA Prof. Blog (Jan. 10, 2013).

⁶⁶ See, e.g. Alcatel Lucent SA (Malaysian telecom entity with 43% public ownership stake was government entity); see Roger Witten *et al.*, *Prescriptions for Compliance with the Foreign Corrupt Practices Act: Identifying Bribery Risks and Implementing Anti-Bribery Controls in Pharmaceutical and Life Sciences Companies*, 64 BUS. LAWYER 691 (May 2009).

⁶⁷ A rare interpretation of the foreign official provision was recently provided by the Eleventh Circuit, but that opinion applied a vague "totality of the circumstances" style test, and appears to have only sown further confusion in this area. *United States v. Esquenazi*, 752 F.3d 912 (11th Cir 2014); see Amy Lynn Soto, *United States v. Esquenazi: Injecting Clarity or Confusion into the Foreign Corrupt Practices Act*, 47 U. MIAMI INTER-AM. L. REV. 383 (2015).

⁶⁸ See Mike Koehler, *THE FOREIGN CORRUPT PRACTICES ACT IN A NEW ERA* 90-98 (2014).

⁶⁹ *Id.*

where the foreign official was obligated by law to provide the benefit but withheld it in order to extort further corporate payments.⁷⁰ In practice, however, that exception has been whittled away to the point of being regarded as “illusory.”⁷¹ Thus, in insurance law parlance, regulatory settlements have expanded the FCPA’s coverage provisions and narrowed its exclusion provisions: the standard which results is that liability can be triggered when a corporation receives a wide range of favorable decisions from a foreign official, whether or not the benefits involved were legally owed to the company in the first place.

A few more significant examples can be noted briefly. The FCPA includes a knowledge requirement for violations of the book-and-records and internal controls provisions: after multiple settlements that turn on those violations, however, the *scienter* element has seemingly been refashioned into a strict liability standard.⁷² The agencies’ jurisdiction over foreign corporations, which is limited by a condition that bribes must be associated with actions that share a “territorial nexus” with the United States, has been extended by settlements that find a “nexus” based on little or no actual contact, and therefore grant the statute an essentially global reach.⁷³ Settlements have also taken statutory language which declares that “anything of value” may constitute a bribe quite literally, and have signaled that the definition can be satisfied not only by cash payments, but also with a wide variety of non-monetary goods (t-shirts; executive training programs) and indirect benefits (charitable donations; internships for relatives).⁷⁴

The track record of FCPA enforcement against individuals reinforces the intuition that the statutory interpretations and theories of liability implicit in the corporate settlements are neither conservative nor obvious. Corporate liability logically entails individual culpability in most instances, yet the DoJ and SEC have largely hesitated to bring parallel actions against individuals.⁷⁵ When they do—

⁷⁰ 1988 amendments to the act Omnibus Trade and Competitiveness Act of 1988, Pub. L. No. 100-418, secs. 5001– 5003, §§ 103(a)–104, 102 Stat. 1107, 1415–25 (amending 15 U.S.C. §§ 78m(b), 78dd-1, 78dd -2, 78ff (1988)).

⁷¹ See Richard Grimes & Sara Zdeb, *The Illusory Facilitating Payments Exceptions: Risks Posed by Ongoing FCPA Enforcement Actions* (2011).

⁷² FCPA § 78m(b)(5). See, e.g., *SEC v. Nature’s Sunshine Products, Inc.*, SEC Release No. 21161 (July 31, 2009); *SEC v. Avery Dennison Corp.*, SEC Release No. 21156 (Jul. 28, 2009); *SEC v. The Dow Chemical Company*, SEC Release No. 2000 (Feb. 13, 2007); see Mike Koehler, *The Façade of FCPA Enforcement*, 41 GEO. J. INT’L L. 907, 976-81 (2010).

⁷³ As established by the 1998 Amendments, foreign corporations may be subject to FCPA liability if they either issue securities on U.S exchanges, or if they have “contact with U.S. territory in furtherance of conduct prohibited by the statute.” 15 U.S.C. § 78m(b)(2)(A); § 78dd-2.; § 78dd-3. See Daniel Patrick Ashe, *The Lengthening Anti-Bribery Lasso of the United States: The Recent Extraterritorial Application of the U.S. Foreign Corrupt Practices Act*, 73 FORDHAM L. REV. 2897, 2902–03 (2005).

⁷⁴ *SEC v. Titan Corp.*, SEC Release No. 1907 (Mar. 1 2005) (campaign t-shirts); *SEC v. UTSarcom, Inc.*, SEC Release No. 21357 (Dec. 31, 2009) (training programs); *SEC v. Schering-Plough Corp.*, SEC Release No. 18740 (donation to Polish hospital); *In re JP Morgan Chase & Co.*, SEC Release No. 79335 (Nov. 17, 2016) (internships for relatives).

⁷⁵ During the 17 year “quiet period” of FCPA enforcement, 20 of 24 DoJ actions against companies also included charges against individuals. In the boom era, less than a quarter, 20 of 84, have done the same. See Koehler, *Foreign Corrupt Practices Act*

presumably in the subset of cases which are strongest on the merits—they frequently fail.⁷⁶ Moreover, the government’s setbacks in court tend to involve the interpretation of key provisions that were reviewed above.⁷⁷ It is revealing that in several cases rejecting the government’s legal theories, the court has specifically admonished prosecutors for citing prior enforcement actions as legal authority.⁷⁸ This suggests that the agencies themselves have internalized the regulation by settlement concept.

In 2012, the DoJ and SEC jointly released a guidance document, titled “A Resource Guide to the U.S. Foreign Corrupt Practices Act” (the FCPA Guidance),⁷⁹ partially in response to growing demands that the agencies produce a more explicit articulation of their theory of the law. But the document was widely panned for adding little new clarity to the agencies’ understanding of what the FCPA means.⁸⁰ Rather than laying out policy positions or enforcement philosophies in unambiguous terms that would provide direction to regulated parties, the FCPA Guidance mostly consists of hypothetical examples that are supported by citations to prior settlements.⁸¹ An ironic result was that it functioned to reaffirm the precedential

Enforcement, *supra* note 54. Neither does the SEC pursue individual charges, which have accompanied only 17% of the agencies’ corporate actions since 2008. Mike Koehler, *Focus on SEC Individual Actions*, FCPA Prof Blog, (Jan. 27, 2015).

⁷⁶ See Paul Barrett, *Federal Prosecutes Keep Losing Trials in Overseas Corruption Cases*, BLOOMBERG (July 23, 2105).

⁷⁷ See, e.g., *SEC v. Jackson*, 908 F. Supp. 2d 834, 855 (S.D. Tex. 2012) (finding that the SEC had failed to meet the preponderance of evidence burden of proof in a “facilitating payments” case against an individual, where it had previously agreed to \$260 million in corporate settlements on the same legal theory); *United States v. Duran* (S.D. Fla. 1990) (rejecting government’s interpretation of “obtain or retain business”); *SEC v. Mattson* (S.D. Tex. 2001) (rejecting government’s interpretation of “obtain or retain business”); *United States vs. Steffen* (S.D.N.Y. 2013) (rejecting the government’s jurisdictional theory); *United States v. O’Shea* (S.D. Tex. 2012) (rejecting the government’s “facilitating payments” theory); *United States v. Goncalves* (D.D.C. 2011) (rejecting government’s “foreign official” theory).

⁷⁸ *United States v. Giffen*, 326 F. Supp. 2d 497 (S.D.N.Y. 2004) (prior record of settlements “is not the kind or quality of precedent this Court need consider”); *United States v. Bodmer*, 342 F.Supp.2d 176 (S.D.N.Y. 2004) (“the Government’s charging decision, standing alone, does not establish the applicability of the statute.”).

⁷⁹ U.S. DEP’T OF JUSTICE CRIM. DIV. & U.S. SEC. & EXCH. COMM’N ENFORCEMENT DIV., A RESOURCE GUIDE TO THE U.S. FOREIGN CORRUPT PRACTICES ACT (2012).

⁸⁰ See Muma, *supra* note 60, at 1344 (“Th[e] [FCPA Guidance] does not expand greatly on what practitioners in the field already know, however, and it does not substantially clarify the underlying uncertainty in the FCPA’s definitions.”); Wachtell Lipton, White Collar and Regulatory Enforcement: Emerging Trends and What to Expect in 2013 (Jan. 7, 2013) (“[T]he FCPA Resource Guide broke little new legal or policy ground[.]”); Joe Palazzolo & Christopher Matthew, *U.S. Attempts to Clarify Antibribery Law*, WALL ST. J. (Nov. 14, 2012) (quoting a former chief of the DoJ’s Fraud Section calling the FCPA Guidance “more of a scrapbook of past DoJ and SEC successes than a guide book for companies who care about playing by the rules.”).

⁸¹ What discernible positions it did stake out had the curious intermediate character: more tentative than settlements yet bolder than court cases that rejected those theories. See Mike Koehler, *Grading the Foreign Corrupt Practices Act Guidance*, BNA White Collar Crime Rep., 07 WCR 961, at 3 (Dec. 14, 2012) (“[P]ast FCPA enforcement actions, in whole or in

value of FCPA settlements rather than displace them with a more traditional policymaking vehicle. Thus, most of the major policy decisions relating to federal anti-corruption law—questions of *scienter*, jurisdiction, what counts as a bribe, who counts as a bribe recipient, what counts as a bribed benefit—have been determined by *de facto* rules promulgated through regulatory settlements.

ii. *The Securitization Settlements*

A major cause of the recent financial crisis was an interconnection between large banks and the housing market that was forged by a multi-step process of financial engineering known as “securitization.”⁸² In the first step of that process, mortgage originators would pool groups of home loans and sell them into trusts held by third-party banks. The banks would then issue certificates from those trusts, which offered investors a fixed cash flow derived from payments on the underlying mortgage loans (Mortgaged-Backed Securities or MBS). In a further iteration, the MBS themselves were securitized, by being pooled and used to back securities known as Collateralized Debt Obligations (CDOs). The earliest use of securitization goes back decades, but markets in MBS and other financial instruments that securitization churns out only grew to be a substantial component of the banking sector following a boom decade that began in the mid-1990s.⁸³

When the housing market deteriorated over the 2006-07 period, homeowners’ rates of default on their mortgages spiked, which in turn led to a collapse in the value of MBS, CDOs, and related financial instruments that were indirectly linked to home loans.⁸⁴ Because large financial institutions had adopted fragile funding models that were vulnerable to any reversals in structured finance markets, a spectacular series of failures followed over the course of 2008, culminating in the bankruptcies of Lehman Brothers and AIG.⁸⁵ Once the financial system eventually stabilized, regulators shifted from the emergency crisis management tactics that characterized “regulation by deal,” and initiated a concerted series of enforcement actions that targeted the banks’ securitization practices leading up to the crisis.

A first round of settlements was spearheaded by the SEC. The opening volley was an investigation of Goldman Sachs—announced while Dodd-Frank was still being hotly debated in Congress—which resulted in a \$550 million settlement that was made public on July 15, 2010, a week before the statute was passed.⁸⁶ The SEC’s underlying claim was that Goldman had misled a pair of European banks that invested in its synthetic CDO transaction, known as ABACUS 2007-AC1, by failing

part, have seemingly run counter to the statements in the Guidance . . . [meanwhile] what the enforcement agencies say in the Guidance has been rejected, in whole or in part, by courts.”).

⁸² Steven L. Schwarcz, *What is Securitization? And for What Purpose?*, 85 S. CAL. L. REV. 1283 (2012).

⁸³ See Viral V. Acharya et al., *REGULATING WALL STREET: THE DODD-FRANK ACT AND THE NEW ARCHITECTURE OF GLOBAL FINANCE* (2011).

⁸⁴ See *id.*

⁸⁵ See Davidoff & Zaring, *supra* note 6.

⁸⁶ SEC. & EXCH. COMM’N, RELEASE NO. 2010-59 (April 16, 2010); WALL ST. J., *The SEC’s Impeccable Timing* (Apr. 20, 2010); SEC. Release, *supra* note 42 (announcing the settlement).

to disclose that a hedge fund manager named John Paulson played a role in selecting the collateral backing the deal while simultaneously betting against it.⁸⁷ The ABACUS investigation was only the first of a campaign of enforcement actions brought by the SEC against the big banks. In each case, the agency alleged that banks had made misrepresentations to investors in connection with the issuance of CDOs or similar structured-finance securities. By mid-2014, every one of those actions were resolved out-of-court with settlement agreements that imposed eight or nine-figure penalties.⁸⁸ In total, the SEC collected \$3.76 billion in fines.⁸⁹

A second round of settlements took place after the Obama administration established the “RMBS Working Group” in 2012, which is an executive branch task force with the specific mission of redressing wrongdoing associated with the financial crisis.⁹⁰ While nominally led by the DoJ, the RMBS Working Group is a multi-agency body that coordinates enforcement efforts among the full alphabet soup of federal financial regulators, along with several state attorneys general.⁹¹ While the SEC followed a transaction-specific approach, with each settlement covering allegations in connection with a particular securitization deal, the RMBS Working Group undertook broader investigations that focused on financial institutions as a whole. Starting in 2014, those efforts quickly yielded a string of blockbuster, multi-billion dollar settlements with the big banks, through which the RMBS Working Group has imposed over \$57 billion in aggregate penalties.⁹²

In addition to the unprecedented dollar amounts involved, one of the most salient features of the Securitization Settlements was their comprehensive reach. The SEC could have aimed its investigative resources at the most egregious instances of wrongdoing, which, presumably, would be associated with transactions at some institutions more than others. Instead, it pursued a conspicuous strategy of “one fine per bank.”⁹³ Similarly, the RMBS Working Group has adopted what could be

⁸⁷ Complaint, *SEC v. Goldman Sachs & Co.*, 790 F. Supp. 2d 147 (S.D.N.Y. 2011).

⁸⁸ Wachovia (\$11m; Apr. 5, 2011); J.P. Morgan (\$153m; June 21, 2011), Citigroup (\$285m; Oct. 19, 2011); J.P. Morgan (\$296m; Nov. 16, 2012); Credit Suisse (\$120m; Nov. 16, 2012); UBS (\$50m; Aug. 6, 2013); Royal Bank of Scotland (\$150m; Nov. 7, 2013); Merrill Lynch (\$131m; Dec. 12, 2013); and Morgan Stanley (\$275m; July 24, 2014). SEC. & EXCH. COMM’N, SEC ENFORCEMENT ACTIONS ADDRESSING MISCONDUCT THAT LED TO OR AROSE FROM THE FINANCIAL CRISIS (Sept. 27, 2016).

⁸⁹ *Id.*

⁹⁰ Press Release, U.S. Dep’t of Justice, U.S. Attorney General Holder, State and Federal Officials Announce Collaboration to Investigate Residential Mortgage-Backed Securities Market (Jan. 27, 2012). The RMBS Working Group is embedded in a broader organization, the Financial Fraud Enforcement Task Force, which was formed by the Obama administration in 2009. Exec. Order No. 13,519, 3 C.F.R. 271 (2009).

⁹¹ Federal agencies associated with the RMBS Working Group included: the SEC, Federal Reserve Board, FDIC, Consumer Protection Finance Bureau (CFPB), Department of Housing and Urban Development (HUD), Federal Housing Finance Agency (FHFA), and National Credit Union Administration (NCUA). *Id.*

⁹² J.P. Morgan Chase (\$13b; Feb. 10, 2014); Citigroup (\$7b; July 13, 2014); Bank of America (\$16.6b; Aug. 21, 2014); Morgan Stanley (\$3.2b; Feb. 11, 2016); Wells Fargo (\$1.2b; Apr. 8, 2016); and Goldman Sachs (\$5b; April 11, 2016); Deutsche Bank (\$7.2b; Dec. 23, 2016); Credit Suisse (\$5.3b; Dec. 23, 2016).

⁹³ See Zaring, *supra* note 28, at 1412-13.

considered a “market share” theory of corporate liability. The institutions singled out for settlement were simply the largest banks in the country; among those settling banks, the bigger the volume of their securitization business, the higher the fine.⁹⁴ The same philosophy is reflected in the individual settlement agreements themselves, which follow a standard format. First there is a Statement of Facts, which recites from an unrelated grab-bag of internal bank communications, all of which betray an embarrassing disregard for due diligence practices and other forms of quality control.⁹⁵ That random assortment of allegations is then accompanied by a blanket assertion of liability for the full population of MBS transactions (usually numbering in the hundreds) that the bank participated in over a multi-year period during the height of the U.S. housing bubble era.⁹⁶ By targeting the banks’ entire course of business and leaving no institution unscathed, the Securitization Settlements sent a signal that the standard practices of the industry as a whole had violated the regulatory rules of the road.

Identifying the exact legal basis that underpinned those rules, however, is far from straightforward. The rapid rise of securitization was not accompanied by the development of a related regulatory framework, and structured finance markets therefore operated within a relative legal vacuum as part of the so-called “shadow banking sector.”⁹⁷ A consequence was that regulators improvised an “eclectic” approach to enforcement that featured a “diversified portfolio” of legal theories.⁹⁸ As in the FCPA context, however, the agencies’ outside-the-box thinking was only minimally embraced by the courts, and “[t]here has not been a single conviction of a bailed-out bank, nor a single senior executive who ran one.”⁹⁹ Thus, the general

⁹⁴ See Ryan Bubb & Prasad Krishnamurthy, *Regulating Against Bubbles*, 163 U. PENN. L. REV. 1539, 1573 (2015) (providing statistics on banks’ securitization activities).

⁹⁵ See, e.g. Goldman Sachs Settlement Agreement, Annex 1: Statement of Facts, <https://www.justice.gov/opa/pr/goldman-sachs-agrees-pay-more-5-billion-connection-its-sale-residential-mortgage-backed>.

⁹⁶ See, e.g., *id.* at Annex 3 (listing covered transactions); see also Floyd Norris, *Citigroup’s Settlement, Pro and Con*, N.Y. TIMES (July 17, 2014) (“But the [DoJ] stops short of identifying which securitizations were affected and never bothers to say whether the securitizations with problems performed worse than others. There is no indication that officials checked to see whether the loans identified as substandard were more likely to default than those the consultants deemed to be proper. There seems to have been no effort to quantify just how much Citigroup’s improper behavior cost investors.”).

⁹⁷ See Erik F. Gerding, *Bank Regulation and Securitization*, 50 GA. L. REV. 89 (2015); Zoltan Polzar et al., *Shadow Banking*, FED. RESRV. BANK N.Y., Staff Rep. No. 458 (Feb. 2012).

⁹⁸ Zaring, *supra* note 28, at 1411 (“These civil suits have relied on a mix of statutes—that is, they did not all turn on violations of the securities laws or on other fraud claims. With various agencies in action, and various bases for litigation, the best way to characterize the government’s civil enforcement strategy is to think of it as a diversified portfolio.”); *id.* at 1412 (“the eclectic approach taken by the government [regarding theories of liability] is likely to be the definitive one for the crisis”).

⁹⁹ Zaring, *id.* at 1438; see also Todd Haugh, *The Most Senior Wall Street Official: Evaluating the State of Financial Crisis Prosecutions*, 9 VA. L. & BUS. REV. 153 (2015); *Cf. U.S. ex rel. O’Donnell v. Countrywide Home Loans, Inc.*, No. 15-496 (2d Cir. May 23, 2016) (reversing a jury verdict of civil fraud against mortgage originator Countrywide, on grounds of insufficient evidence).

picture that arises from the Securitization Settlements is an industry-wide imposition of fines that is not conditioned on a clear connection between particular acts of wrongdoing nor a widely recognized, preexisting legal basis for liability.

The SEC settlements, for example, were premised on the banks having committed federal securities fraud, but that same theory did not gain traction in cases that were litigated against individuals. An important early test was a DoJ case that brought criminal securities fraud charges against two Bear Stearns hedge fund managers. When both individuals were acquitted on all counts, the DoJ was forced to reassess its financial crisis litigation strategy more generally, and subsequently dropped most of its other pending investigations.¹⁰⁰ Meeting civil standards of proof was not noticeably easier.¹⁰¹ An SEC litigation against Citigroup trader Brian Stoker led to a jury verdict that rejected the government's theory of liability, even though the allegations in that case concerned the very same CDO transaction that was the basis for a \$285 million settlement with the bank itself.¹⁰² The SEC's most prominent success in a securitization case, a jury verdict against Goldman Sachs' employee Fabrice Tourre for civil securities fraud, is best understood as an idiosyncratic exception that proves the rule.¹⁰³

Rather than invoke the federal securities laws, the RMBS Working Group settlements relied on a creative patchwork of statutes that had previously been of limited applicability to banking regulation.¹⁰⁴ One of these was FIRREA, a law passed in response to the 1980s savings-and-loan crisis, which imposes civil liability for acts of fraud committed against banks with federally-insured deposits.¹⁰⁵ FIRREA had never before been used against bank entities, only against individuals.¹⁰⁶ But the statute gained legs in connection with the government's novel

¹⁰⁰ See Zachery Kouwe & Dan Slater, *Two Bear Stearns Fund Leaders Are Acquitted*, N.Y. TIMES (Nov. 11, 2009) (Ralph Cioffi and Matthew Tannin); Jean Eaglesham, *Financial Crimes Bedevil Prosecutors*, WALL ST. J. (Dec. 6, 2011) (DoJ dropping cases that were being prepared against AIG executive Joseph Cassano and Countrywide CEO Angelo Mozilo).

¹⁰¹ Zaring, *supra* note 28, at 1411.

¹⁰² *SEC v. Stoker*, 865 F. Supp. 2d 457 (S.D.N.Y. 2012). A nearly identical scenario played out again when the SEC dropped its case against another individual, Edward Steffelin, which was based on allegations that resulted in a \$296 million settlement with J.P. Morgan for the same underlying CDO transaction. See Peter Henning, *Mixed Results for SEC in Financial Crisis Cases*, N.Y. TIMES (Nov. 19, 2012).

¹⁰³ Tourree was a mid-level financial engineer rather than a decision-making executive, and was rendered particularly unsympathetic by emails in which he declared himself the "Fabulous Fab" and claimed credit for ushering in a financial apocalypse. See Aaron Smith & James O'Toole, *'Fabulous Fab' Held Liable in Goldman Fraud Case*, CNNMoney, (Aug. 1, 2013).

¹⁰⁴ Nick Timiraos *et al.*, *U.S. Steps Up Loan Scrutiny*, WALL ST. J., (May 21, 2011) ("The Justice Department has instructed federal prosecutors to be creative in adapting decades-old laws to take action against Wall Street.").

¹⁰⁵ Financial Institutions Reform, Recovery, and Enforcement Act, Pub. L. No. 101-73, 101 Stat. 183 (1989); 12 U.S.C. § 1833a; see Nan S. Ellis, Steven B. Dow, & David Safavian, *Use of FIRREA to Impose Liability in the Wake of the Global Financial Crisis*, 18 U. PA. BUS. L. REV. 119 (2015).

¹⁰⁶ Ellis *et al.*, *supra* note 105, at 135, n.75 ("Although FIRREA was enacted in 1989, it was virtually ignored as a vehicle to address financial fraud until the [financial crisis] . . .

“self-affecting” theory, which turned on the idea that the defrauded bank and settling bank were one and the same.¹⁰⁷ Another legal component of the RMBS Working Group settlements was the False Claims Act (FCA), a Civil War era *qui tam* statute that prohibits false statements made to agencies in connection with government contracts or the receipt of other public benefits.¹⁰⁸ The FCA was foreign to financial regulation prior to 2008, but was applied on the theory that the banks had made false statements to government housing agencies (Fannie Mae, Freddie Mac, or HUD) in the process of certifying mortgages that were used in securitizations.¹⁰⁹ A third legal authority that was invoked were state “blue sky laws,” which predate the Great Depression and had been largely dormant since.¹¹⁰ During the rise of structured finance markets, it is unlikely that any of these statutes or associated theories of liability were perceived as the governing legal backdrop for banks’ securitization practices.

Taken at face value, the Securitization Settlements carry a startling implication: every major bank, in connection with every securitization deal, had simultaneously defrauded investors (under federal and state securities laws), the government (the False Claims Act), and themselves (FIRREA). But that vision of omnipresent fraud lacks plausibility, not only due to its inherent oddness, but also in light of the paltry success of related claims that reached adjudication on the merits. A more convincing interpretation is that the underlying conduct, as economically destructive as it proved to be, did not involve fraud in the conventional sense of intentional deception.¹¹¹ Rather, the banks which bought and sold securitized assets from one another had formed a circular firing squad of collectively misguided risk-taking.¹¹² When a generalized drift toward lax risk management met an historic drop

Previous, FIRREA had been used primarily against officers and directors of failed financial institutions.”).

¹⁰⁷ *Id.*

¹⁰⁸ False Claims Act, 31 U.S.C. §§ 3729-3733 (2006) (*as amended by* Fraud Enforcement and Recovery Act of 2009, Pub. L. No. 111-21, 123 Stat. 1617); U.S. DEP’T OF JUSTICE, *THE FALSE CLAIMS ACT: A PRIMER* (2010).

¹⁰⁹ See Gibson Dunn, *FINANCIAL INSTITUTIONS IN THE CROSSHAIRS: THE FALSE CLAIMS ACT AND FIRREA* (Oct. 2, 2013).

¹¹⁰ The most prominent blue sky law is New York’s Martin Act. N.Y. GEN. BUS. LAW § 353 (Consol. 2012) (permitting suits against anyone who “has engaged in, is engaged or is about to engage in any of the transactions heretofore referred to as and declared to be fraudulent practices”); see Roberta S. Karmel, *Appropriateness of Regulation at the Federal or State Level: Reconciling Federal and State Interests in Securities Regulation in the United States and Europe*, 28 *BROOK. J. INT’L L.* 495, 544 n.272 (2003) (reporting that the Martin Act was rarely used “except to prosecute local scams” for most of its history).

¹¹¹ See Hilary J. Allen, *The Pathologies of Banking Business as Usual*, 17 *U. PA. J. BUS. L.* 861, 876 (2015); Daniel Richman, *Corporate Headhunting*, 8 *HARV. L. & POL’Y REV.* 265 (2014); Samuel W. Buell, *What Is Securities Fraud?*, 61 *DUKE L. J.* 511 (2011); cf. Mitu Gulati et al., *Fraud by Hindsight*, 98 *Nw. U. L. Rev.* 773 (2004).

¹¹² See Arnold Kling, *The Financial Crisis: Moral Failure or Cognitive Failure?*, 33 *HARV. J. L. & PUB. POL’Y* 507 (2010); Geoffrey P. Miller & Gerald Rosenfeld, *Intellectual Hazard: How Conceptual Biases in Complex Organizations Contributed to the Crisis of 2008*, 33 *HARV. J. L. & PUB. POL’Y* 807 (2010).

in housing prices, the worst case scenario materialized.¹¹³ Because that chain of events was nonetheless subject to a comprehensive sweep of regulatory settlements that imposed record-setting fines, a novel regulatory “rule” emerges. The implicit legal standard is that banks can be held liable (on a nearly unlimited dollar basis) for engaging in negligent or grossly negligent business practices when participating in securitization markets.

A complicating factor is that the Securitization Settlements occupy the same regulatory space as the Dodd-Frank Act, which is conventionally understood to represent an overhaul of the law of securitization.¹¹⁴ However, Dodd-Frank does not preempt the regulatory standard laid down by the Securitization Settlements, because its rules are merely redundant with preexisting industry practice and also narrower than the theories of liability that animated the settlements. For example, Section 941 of Dodd-Frank provides “risk retention rules,” which require banks to hold a portion of the securities (roughly five percent) that are issued from their securitization.¹¹⁵ But risk retention was already standard prior to the financial crisis.¹¹⁶ In fact, all of the RMBS Working Group settlements involved banks that had retained greater than twenty percent of the risk from their securitization deals, which is more than four times the new “requirement” set out by Dodd-Frank.¹¹⁷

Another relevant Dodd-Frank provision is Section 942(b), which sets out new disclosure rules that require banks to disclose information regarding the financial assets backing each class of securities that are issued as part of a securitization.¹¹⁸ As with risk retention, the sort of disclosures contemplated by Section 942(b) were already the industry norm. Most securitizations were accompanied by a battery offering documents—“term sheets,” “offering circulars,” “free writing prospectuses,” “prospectus supplements”—which contained hundreds of pages of statistics that described the securities being sold.¹¹⁹ The irrelevance of

¹¹³ *Id.*

¹¹⁴ Steven L. Schwarcz, *Securitization and Post-Crisis Financial Regulation*, 101 CORNELL L. REV. ONLINE (2016) (stating that the “U.S. regulatory response to securitization [is] primarily embodied in the Dodd-Frank Act”).

¹¹⁵ 15 U.S.C. § 78o-11 (2010). The rationale for Dodd-Frank’s risk retention rule is that, by forcing banks to retain a portion of the credit risk that is passed along to investors, they will be incentivized to do greater due diligence on the collateral backing the deal. *See* Bubb & Krishnamurthy, *supra* note 94.

¹¹⁶ *See* Bubb & Krishnamurthy, *supra* note 94, at 1545 (“The market-determined level of risk retention by securitizers during the recent boom was in fact too high, not too low. The same Wall Street banks that led the league tables for the creation of MBS also bore much of the brunt of the losses when the underlying loans failed.”); ACHARYA, *supra* note 83, at 469 (“Financial institutions actually held on to large chunks of (mostly senior) tranches of their securitized assets.”); Schwarcz, *supra* note 114, at 13 (“In my experience, the market itself has always mandated risk-retention. Prior to the financial crisis, for example, originators and sponsors of securitizations usually retained risk on the financial assets, typically mortgage loans, included in those transactions.”).

¹¹⁷ Bubb & Krishnamurthy, *supra* note 94, at 1537 (Chart 1).

¹¹⁸ 15 U.S.C. §77g(c) (2010); *see also*, Section 945 (regarding disclosure of due diligence); *id.* § 77g(d).

¹¹⁹ Schwarcz, *supra* note 115, at 11 (“Prior to the financial crisis, the risks associated with complex securitization transactions and their underlying financial assets, including

Section 942(b) is best illustrated by Goldman Sachs' \$550 million ABACUS settlement. There, the SEC focused on a failure to disclose "soft" circumstantial information regarding the role of certain parties involved in the deal, and did not allege any misrepresentations or omissions regarding the financial characteristics of the securities at issue.¹²⁰ Thus, conduct that is prohibited under the new Dodd-Frank rules never actually took place during the financial crisis, while conduct that would be in perfect compliance with those rules resulted in across-the-board regulatory settlements that imposed billions of dollars in penalties. The real overhaul of the regulatory framework for securitization was installed through the Securitization Settlements, rather than by Dodd Frank.

iii. *The Benchmark Settlements*

An important part of the banking system involves the use financial benchmarks, which are aggregation devices that reflect marketwide prices and are often incorporated into contractual terms.¹²¹ The most famous of these, Libor (the London Inter-Bank Offered Rate), is an index that is calculated based on banks' estimates of their borrowing costs and then factored into the price of interest rate swaps.¹²² Because Libor represents the lowest interest rate that the market will bear at a given time, it is also widely relied upon as a baseline to price consumer debt—such as mortgages, credit cards and student loans—and has therefore been called "the world's most important number."¹²³ Benchmarks are also critical in foreign exchange markets, where the W/M/Reuters index is a popular tool for pricing currency swaps and other financial contracts that are used in the five trillion dollar market associated with hedging exchange rate fluctuations.¹²⁴ The regulation of benchmarks was fundamentally changed by two sweeping waves of settlements concerning allegations that various banks had been manipulating, or "rigging," the calculation of Libor (the Libor Settlements) and the W/M/Reuters index (the ForEx Settlements) (together, the Benchmark Settlements).

The path to the Libor Settlements began on May 29, 2008, when a Wall Street Journal article raised suspicions that the banks were manipulating the benchmark by reporting their borrowing costs in a strategic manner.¹²⁵ That eventually lead to an investigation of Barclays by the CFTC, which ended with

subprime mortgage loans, were fully disclosed"); *see also* Steven L. Schwarcz, *Disclosure's Failure in the Subprime Mortgage Crisis*, UTAH L. REV. 1109 (2008).

¹²⁰ *See* Stephen M. Davidoff, *The SEC v. Goldman Sachs: Reputation, Trust, and Fiduciary Duties in Investment Banking*, 37 J. CORP. L. 529, 541-42 (2012).

¹²¹ *See* Andrew Verstein, *Benchmark Manipulation*, 56 B.C. L. REV. 215, 217 (2015).

¹²² Melissa Anne Conrad-Alam, *All Together Now: International Regulatory Response to the LIBOR Rate Setting Conspiracy*, 42 GA. J. INT'L & COMP. L. 491, 492 (2014).

¹²³ *Id.* at 492.

¹²⁴ *See* FIN. STAB. BD., FOREIGN EXCHANGE BENCHMARKS (July 15, 2014).

¹²⁵ Carrick Mollenkamp & Mark Whitehouse, *Study Casts Doubt on Key Rate*, WALL ST. J. (May 29, 2008). Libor is "fixed" daily, based on voluntary submissions by a panel of approximately sixteen large banks, which provide estimates of the rate at which they anticipate being able borrow over variously time intervals (e.g. three months) and in different currencies. It is calculated as the average of the reported the rates after high-and-low outliers have been dropped. *See* Conrad-Alam, *supra* note 122, at 494-96.

Barclays entering into three separate settlements on June 27, 2012—one with the CFTC (\$200 million), another with the DoJ (\$160 million), and a third with the UK Financial Services Authority (£59.5 million).¹²⁶ The Barclays settlement involved three underlying allegations. First, that Barclays’ swaps traders in New York had been communicating with the banks’ money market desk in London, and requesting that the London office alter its Libor submissions upwards or downwards, in order to push the benchmark in a direction that would favor Barclays in its trades with clients.¹²⁷ Second, that separate requests to coordinate Libor submissions had been made between Barclays traders and traders at other banks, with the same aim of front-running clients.¹²⁸ And third, that high-level managers at Barclays had under-reported Libor submissions to regulators around the 2007-08 period—a time when every large financial institution was being scrutinized as potentially on the brink of collapse—in an attempt to make the bank’s financial position appear stronger.¹²⁹ The Barclays settlement sparked a broader investigation, which quickly produced a series of agreements among the CFTC, DoJ, FDIC, UK authorities and other banks that had a role in setting in Libor.¹³⁰ Enforcement of the Libor manipulation scandal resulted in settlements totaling \$9 billion.

An eerily similar chain of events was set in motion on June 12, 2013, when an international group of regulators opened wide-ranging investigations into the possible manipulation of the W/M/Reuters benchmark in foreign exchange markets.¹³¹ While ForEx benchmarks are aggregated based on actual trades, rather than submissions that estimate borrowing costs, those probes uncovered evidence that traders coordinated within and across firms—including in chat rooms with unhelpful names like “the cartel”—to strategically concentrate transactions in the trading window that was used to calculate W/M/Reuters, with the aim of biasing the benchmark in directions that were advantageous to the banks’ trading positions.¹³² A surge of regulatory settlements followed, which managed to exceed the Libor Settlements in scale. On November 11, 2014, the CFTC announced nine-figure settlements with five banks and, on that same day, the OCC finalized three separate settlements of equal magnitude.¹³³ On May 20, 2015, the DoJ settled criminal charges through agreements with five banks, one of which was joined by the New

¹²⁶ N.Y. TIMES DEAL BOOK, *Tracking the Libor Scandal* (Mar. 23, 2016).

¹²⁷ *In re Barclays PLC*, Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act, CFTC Docket No. 12-25 (June 27, 2012).

¹²⁸ *Id.*

¹²⁹ *Id.*

¹³⁰ UBS (\$1.5b; Dec. 19, 2012); Royal Bank of Scotland (\$612m; Feb. 6, 2013); ICAP (\$87m; Sept. 25, 2013); Radobank (\$1b; Oct. 29, 2013); Deutsche Bank (\$2.5b; Mar. 23, 2015). The FDIC settled with Bank of America on February 1, 2012 for \$200 million. N.Y. TIMES, *Tracking the Libor Scandal*, *supra* note 126.

¹³¹ See Phillipa Leighton-Jones & Stephen Grocer, *How the FX Probe Unfolded*, WALL ST. J. (Nov. 12, 2014).

¹³² *Id.*

¹³³ The CFTC settled with: Citibank (\$310m), HSBC (\$275m), JP Morgan (\$310m), RBS (\$290m), and UBS (\$290m). The OCC settled with: Bank of America (\$250m), JP Morgan (\$350m), and Citibank (\$350m). See Matt Levine, *Bank FX Fine Scorecard*, BLOOMBERG (May 20, 2015).

York Department of Financial Services (NY DFS), while the Federal Reserve Board announced civil settlements with the same group.¹³⁴ Total penalties associated with the ForEx settlements equaled \$10.3 billion.

The core features of the Benchmark Settlements closely paralleled aspects of the Securitization Settlements that allowed regulators to use those agreements to engage in *de facto* regulatory rulemaking. Namely: (1) massive penalties that were applied on a comprehensive, industrywide scale; (2) the imposition of those penalties through enforcement actions that nearly all concluded with corporate settlements; and (3) the assertion of creative theories of liability that did not closely track any preexisting regulatory framework.

The Benchmark Settlements signaled that the reliability of the Libor and ForEx indices was undermined by a widespread set of standard practices, rather than an outlier group of malfeasant firms. Libor is calculated by a panel of sixteen banks, and almost every member of the that panel became a party to regulatory settlements. Moreover, although the Barclays settlement publicized a collection of outrageous quotes from bankers who were brazenly trading rigged submissions in exchange for bottles of champagne and the like, it eventually became clear that such behavior was not particularly shocking to industry veterans, who assumed that the Libor numbers had been massaged at the margins for decades.¹³⁵ Likewise, ForEx markets are relatively concentrated, with about ten banks transacting in the trading window that is used to calculate W/M/Reuters and similar benchmarks.¹³⁶ All or nearly all of those banks entered into nine-figure settlements with regulators. And, in the ForEx context, the underlying conduct may also have been roughly in line with the expectations of market participants: funneling trades into the relevant window in which the benchmark is “fixed” is to a certain extent a required practice, albeit one that need not be performed in an aggressively opportunistic manner.¹³⁷ Thus, as with the Securitization Settlements, liability was attached to the normal course of dealing of an entire industry.

Once again, the dominant procedural vehicle for imposing liability was corporate settlement. All \$19.3 billion in penalties were extracted in connection with out-of-court settlements, which were negotiated without a single defendants’ legal brief being filed in either administrative or federal court. While certain of the DoJ’s ForEx settlements were nominally styled as “guilty pleas,” rather than deferred prosecution agreements, that label was misleading. The admissions of guilt in those documents were immediately followed by waivers that negated any of the collateral consequences that are usually associated with guilty pleas—namely, ineligibility for government contracting and collateral estoppel in follow-on civil suits—and were therefore treated by markets as indistinguishable from pretrial diversion agreements

¹³⁴ The DoJ settled with: Citigroup (\$925m); JP Morgan (\$550m); Barclays (\$650m); joined by the NY DFS for an additional \$60m); RBS (\$395m); and UBS (\$203m). The Federal Reserve Board settled with: Citigroup (\$342m); JP Morgan (\$342m); Barclays (\$342m); RBS (\$274m); Bank of America (\$205m); and UBS (\$342m). *Id.*

¹³⁵ See, e.g., Douglas Keenan, *My Thwarted Attempt to Tell of LIBOR Shenanigans*, FIN. TIMES (July 26, 2016); THE ECONOMIST, *The Rotten Heart of Finance* (July 7, 2012).

¹³⁶ Verstein, *supra* note 121, at 237-38.

¹³⁷ See Levine, *supra* note 133.

that contained no such admissions.¹³⁸ And as with the financial crisis litigations, related actions against individuals were sparse, directed exclusively at low-level traders, and were rejected on the merits more often than not.¹³⁹

Most importantly, the Benchmark Settlements amounted to an implicit exercise in progressive regulatory rulemaking, rather than a crackdown on clearcut violations of a well-established, preexisting legal prohibition. As it turned out, there was no “benchmark regulation” whatsoever at the time the manipulation allegations surfaced.¹⁴⁰ The Libor system was managed by the British Bankers Association (BBA), a now-infamous gentleman’s agreement governed by the very same panel of banks that made the submissions which were aggregated into the benchmark rate.¹⁴¹ The ForEx benchmark was similarly supervised by a light-touch association of industry members, known as the London Foreign Exchange Joint Standing Committee.¹⁴² The minimalist state of benchmark regulation is best illustrated by the fact that the BBA was the first to be informed of the allegations underlying the Barclays settlement, undertook a perfunctory investigation in 2008, and concluded within a matter of months that no major changes needed to be made to the system.¹⁴³

As a result of this regulatory void, the Benchmark Settlements invoked a bewildering mix of statutes and legal theories, none of which were squarely applicable to the conduct at issue.¹⁴⁴ For example, the OCC, FDIC, and Federal Reserve Board settlements all rely on a catchall provision from the Federal Deposit Insurance Act (FDIA), which prohibits practices that are inconsistent with maintaining the overall “safety and soundness” of a bank.¹⁴⁵ Yet those settlements do not explain how the banks’ finances were rendered more fragile by the (profitable) manipulation of the Libor or ForEx benchmarks.¹⁴⁶ Instead, they imply that the relevant unsafe practices involved the banks’ failure to detect their employees’ attempts to manipulate those financial benchmarks. As a result, the findings of liability in those settlements are entirely derivative of an underlying

¹³⁸ See Hugh Son & Elizabeth Dexheimer, *Once-Unthinkable Criminal Pleas by U.S. Banks Get Investor ‘Meh’*, BLOOMBERG (May 20, 2015).

¹³⁹ See Lindsay Fortado, *Jury Acquits Five of Six Brokers in Libor Trial*, FIN. TIMES, (Jan. 27, 2016); see also Caroline Binham, *Justice Department Weighs Charges Against London ForEx Traders*, FIN. TIMES (Apr. 22, 2016).

¹⁴⁰ Gina-Gail S. Fletcher, *Benchmark Regulation*, 102 IOWA L. REV. 1, 4 (forthcoming 2017).

¹⁴¹ See Conrad-Alam, *supra* note 122, at 498-50 (reviewing oversight of Libor by the BBA).

¹⁴² *Id.* at 498.

¹⁴³ See Stephen M. Bainbridge, *Reforming LIOBR: Wheatley Versus the Alternatives*, 9 NYU J. L. & BUS. 1, at 11 (2013).

¹⁴⁴ See Milson C. Yu, *Libor Integrity and Holistic Domestic Enforcement*, 98 CORNELL L. REV. 1271, 1276 (2013) (“The conclusion, then, is quite clear: contemporary statutory and regulatory regimes are inadequate to effectively capture reference rates and holistically enforce against their manipulation.”).

¹⁴⁵ Federal Deposit Insurance Act, Section 8(b)(1); 12 U.S.C. § 1818(i). See, e.g. *In re JPMorgan Chase Bank, N.A.*, Consent Order for a Civil Money Penalty, OCC Docket No. 2014-172 (Nov. 11, 2014).

¹⁴⁶ *Id.* at ¶ 14.

theory of wrongdoing that is never articulated and presumed to have been established elsewhere.

The antitrust violations asserted in the DoJ's settlements are also awkward in the benchmark context. For instance, the underlying allegations were that the banks had colluded to *underestimate* Libor in many cases, and thereby lowered prices for end-users of debt contracts as often as not.¹⁴⁷ More importantly, antitrust claims by definition only apply to behavior that is coordinated among firms, and cannot reach attempts at benchmark manipulation—no matter how egregious—that take place within a single firm.

The common denominator across the Benchmark Settlements were agreements involving the CFTC, which were premised on a dual violation of both the fraud and manipulation prohibitions contained in the Commodities & Exchange Act (CEA).¹⁴⁸ It has been widely recognized by commentators, however, that each theory runs into fundamental conceptual and evidentiary problems. The CFTC's commodities manipulation claims are weak because, among other reasons, it is difficult to construe financial benchmarks as "commodities." The fraud claims are undermined by the fact that manipulation of the ForEx benchmark involved strategically timed trades, not deceptive statements.¹⁴⁹ Nor do Dodd Frank's amendments to the CEA's fraud provisions—which move the relevant legal standard closer to the 10b-5 rule that prevails in securities law—completely close those gaps.¹⁵⁰

As should be clear, the precise admixture of legal theories that underpinned the Benchmark Settlements is somewhat beside the point. By extracting penalties from every bank that had a significant role in Libor and ForEx swap markets, using whatever statute happened to be on hand, administrative agencies leveraged the settlement of enforcement actions to establish a new regulatory norm. Roughly stated, the controlling rule is that liability for manipulation of a financial index will be forthcoming whenever data or trades are submitted in a strategic manner that undermines the overall integrity of the final benchmark rate.¹⁵¹

In addition to that background standard, the Benchmark Settlements also incorporated terms that established new rules governing banks' day-to-day administration of the financial benchmarks. This was accomplished through the CFTC-Barclays agreement, which set forth a roughly twenty-page template of detailed procedural reforms that was mechanically grafted onto subsequent Libor

¹⁴⁷ See Sharon E. Foster, *Libor Manipulation and Antitrust Allegations*, 11 DEPAUL BUS. & COMM. L. J. 292 (2013).

¹⁴⁸ See CEA Sections 6(c), 6(d), 9(a)(2); see, e.g., Barclays Settlement, *supra* note 127.

¹⁴⁹ It is also hard to establish the fraud element of reliance when the rigging at issue was an open secret among industry actors, who worked together to move benchmark prices. See Yu, *supra* note 144, at 1277, 1291 (making these points); Fletcher, *supra* note 140, at 8 (same); Verstein, *supra* note 121, at 255-58 (same).

¹⁵⁰ Dodd-Frank amended Sections 4 and 6(c)(1) of the CEA, and the CFTC promulgated a pair of associated rules, known as Reg. 180.1 and Reg. 180.2 *But see* Verstein, *supra* note 121 (Dodd-Frank amendments, even if retrospectively applied, would not have covered all of the conduct at issue in the Benchmark Settlements).

¹⁵¹ *Cf.* Verstein, *supra* note 121, at 261.

settlements.¹⁵² The prescriptive quality of the Benchmark Settlements is most apparent in light of parallel reform efforts in the UK, where the leading policy document (known as the Wheatley Report) explicitly endorses the procedures outlined in the CFTC-Barclays settlement and adopts them as the defining guidelines for Libor submissions by UK banks going forward.¹⁵³ Thus, in the case of the Benchmark Settlements, regulatory settlements have been used both to fashion a new regulatory prohibition, which covers a broad range of attempts at rate “manipulation,” and to lay down a standardized framework for how the calculation of certain indices is managed.

C. Summary

The three case studies presented above include some of the clearest and most impactful episodes of regulation by settlement. But they nonetheless represent an illustrative rather than exhaustive set of examples. Within the past decade, many other areas of banking regulation have been fundamentally altered by agencies engaging in settlement-only enforcement booms. Four additional cases are worth noting in order to highlight the pervasive reach of regulation by settlement, but will be surveyed in passing for purposes of space.

One further example involves enforcement actions against banks that originated and serviced residential mortgages (the Mortgage Servicing Settlements). From 2010 to 2012, the OCC, Federal Reserve Board, and Department of Housing and Urban Development (HUD), entered into a sweeping series of settlements with banks relating to their foreclosure practices, which imposed a total of \$25 billion in penalties.¹⁵⁴ Like the Securitization Settlements, the Mortgage Servicing Settlements took a comprehensive “market share” theory of liability in order to reform the industry as a whole: the five largest settlements were with banks that had the five highest volumes of foreclosures.¹⁵⁵ Another example is a collection of

¹⁵² For example, the Barclays Settlement sets out specific factors that may be used in calculating Libor, how they are to be weighed relative to one another, and so on. Barclays Settlement, *supra* note 127; see Hester Pierce, *Regulating Through the Backdoor at the Commodities Futures Trading Commission*, MERCATUS CNTR. WK’G PPR. at 59-60 (Nov. 2014). Although such terms bear a superficial resemblance to the internal governance provisions that are routinely included in DoJ pretrial diversion agreements, they are in fact much more substantive in nature because the underlying content of benchmark regulation is procedural, and consists of the protocols that are used to aggregate those indices. Compare Barclays Settlement, *supra* note 127, with UBS Non-Prosecution Agreement, U.S. Dep’t of Justice: Criminal Division (Dec. 18, 2012) (setting out the standard NPA compliance terms).

¹⁵³ See THE WHEATLEY REVIEW OF LIBOR: FINAL REPORT, 29 ¶ 4.9 (2012) (“These [Libor] submission guidelines are closely modelled on the undertakings proposed by the Commodity Futures Trading Commission (CFTC) in their settlement with Barclays Bank Plc.”).

¹⁵⁴ See generally Sally Scott & Jerry Anthony, *National Mortgage Settlement*, U. Iowa Wk’g Paper (Oct. 2012).

¹⁵⁵ See *id.* Like the CFTC’s agreements in the Benchmark Settlements, the OCC and Federal Reserve Board agreements contained vast remedial terms, which went beyond enhanced compliance procedures and dictated a new set of substantive industry standards governing foreclosures on mortgage loans. See OFFICE OF COMPTROLLER OF CURRENCY, FORECLOSURE-RELATED CONSENT ORDERS STATUS REPORT (Apr. 2014).

settlements that focused on the internal procedures that banks use to detect money laundering activities that take place through client accounts (the Anti-Money Laundering Settlements).¹⁵⁶ A third case concerns settlements pursued by the DoJ and the Treasury's Office of Foreign Assets Control (OFAC), which invoke executive orders that place economic sanctions on certain foreign governments, and allege that banks failed to deter or detect financial transactions with those countries (the Foreign Sanctions Settlements).¹⁵⁷ A final example is the Swiss Bank Settlements, in which the DoJ entered into *seventy-eight* NPAs with internationally-active financial institutions within a two-year span over the course of 2015 and 2016, all arising from claims that subsidiary banks located in Switzerland were used as tax havens that illegally sheltered the assets of U.S. citizens.¹⁵⁸

This section has walked through multiple series of settlements in a highly granular way, but that level of detail is necessary to move beyond truisms, such as the point that enforcement decisions can influence policy, or that out-of-court settlement agreements have become more common. The analysis thereby shows that recent enforcement episodes share a number of subtle features which, taken collectively, represent a regime change in financial regulation. Time and again, regulatory settlements have been used on a systematic scale to indirectly promulgate novel legal standards, and thereby reshape how the banking system operates along important dimensions. In these areas, the legal center of gravity now consists of a body of settlement agreements, while traditional textual authorities (statutes, judicial opinions, regulatory rules, agency policy statements, the rulings of administrative courts, and so on) are limited to the periphery. One consequence is that, contrary to conventional wisdom, post-crisis financial regulation is not wholly the domain of the Dodd-Frank Act. Instead, regulation by settlement has emerged as a parallel form of regulation that stands alongside that statutory framework.

III. Regulation by Settlement & the Administrative State

This Section explores the significance of regulation by settlement within the broader context of administrative law, and argues that its unique procedural features represent a novel form of agency policymaking. Part A outlines the legal balancing of discretion and constraint which characterizes the standard model of regulation in the administrative state. Part B demonstrates how regulation by settlement departs

¹⁵⁶ The list of agencies that took part in the Anti-Money Laundering Settlements includes the DoJ, the OCC, the Federal Reserve Board, and the "FinCEN" unit of the Treasury Department. The underlying legal basis for corporate liability turned primarily on alleged violations of the Bank Secrecy Act. See Sharon Brown-Hruska, *Developments in Bank Secrecy Act and Anti-Money Laundering Enforcement and Litigation*, NERA ECON. (June 2016); Lanier Saperstein et al., *The Failure of Anti-Money Laundering Regulation: Where is the Cost-Benefit Analysis*, 91 NOTRE DAME L. REV. ONLINE (2015); Olivia A. Radin, *A Rising Tide of AML Reg Actions*, LAW360 (Mar. 31, 2015).

¹⁵⁷ See Victoria Anglin, *Why Smart Sanctions Need a Smarter Enforcement Mechanism: Evaluating Recent Settlements Imposed on Sanction-Skirting Banks*, 104 GEO. L. J. 693 (2016).

¹⁵⁸ See Garrett, *supra* note 41, at 38; GIBSON DUNN, *supra* note 37, at n.1; U.S. DEP'T JUSTICE, SWISS BANK PROGRAM, <https://www.justice.gov/tax/swiss-bank-program>.

from those baseline principles, by comparing the recent use of regulatory settlements against more conventional modes of agency action. In the process, the discussion that follows aims to shed light on the current divide between scholarship on financial regulation and administrative law, and takes some steps to bridge that gap.

A. Background Principles of Regulatory Policymaking

Administrative law scholarship circulates around certain points of consensus which can be understood to collectively reflect a standard model of how the modern regulatory state operates. An initial premise is that administrative agencies are the predominant source of national public policy. Although Congress is vested with legislative authority under Article I of the Constitution, it has nearly unlimited leeway to make a *de facto* delegation of that authority to the executive branch, so long as the statute that does so contains an “intelligible principle” that provides some minimal guidance as to what transfer has taken place.¹⁵⁹ In practice such wholesale delegations are commonplace, and legislation frequently sets out only the barest outlines of political consensus.¹⁶⁰ Administrative agencies therefore go much further than filling in the gaps left by ambiguous statutory language,¹⁶¹ and instead do the real work of policymaking that determines the substance of how the federal government actually governs.¹⁶²

Concentrating policymaking discretion in the executive branch is considered a defensible institutional division of labor, rather than an act of Congressional abdication.¹⁶³ The justification is that agencies’ superior decision-making flexibility and technocratic expertise relative to Congress make them more adept at intervening in the complex problems that arise in an advanced capitalist society.¹⁶⁴ A further point is that, in order to meaningfully exploit those advantages, agencies must necessarily exercise an overlapping combination of legislative, executive, and judicial functions in a way that may (superficially, at least) appear to be in tension with traditional

¹⁵⁹ See *Whitman v. Am. Trucking Ass’n, Inc.*, 531 U.S. 457 (2011) (setting out the “intelligible principle” requirement of the nondelegation doctrine).

¹⁶⁰ See Adrian Vermuele & Eric A. Posner, *Interring the Nondelegation Doctrine*, 69 U. CHI. L. REV. 1729 (2002); Mark Seidenfeld, *Bending the Rules: Flexible Regulation and Constraints on Agency Discretion*, 51 ADMIN. L. REV. 429, 438-39 (1999).

¹⁶¹ For the inevitability of broad administrative policymaking, see Bressman, *supra* note 1, at 1758-67; Stewart, *supra* note 1, at 1669-70.

¹⁶² See William N. Eskridge Jr. & John Ferejohn, A REPUBLIC OF STATUTES: THE NEW AMERICAN CONSTITUTION 10 (2010) (“[I]n the modern administrative state, commissions and bureaus promulgate most legally binding rules.”); Gary Lawson, *The Rise and Rise of the Administrative State*, 107 HARV. L. REV. 1231 (1994).

¹⁶³ Administrative bodies are often subdivided into “executive” agencies, housed within the traditional executive departments, such as Treasury, and “independent” agencies, such as the SEC and CFTC, with the latter having a different appointment and removal structure. See Lisa Schultz Bressman & Robert B. Thompson, *The Future of Agency Independence*, 63 VAND. L. REV. 599, 610 (2010); Adam J. Levitin, *The Politics of Financial Regulation and the Regulation of Financial Politics: A Review Essay*, 127 HARV. L. REV. 1991, 2042-49 (2014) (examining relevance of distinction in context of financial regulatory agencies).

¹⁶⁴ See James Landis, THE ADMINISTRATIVE PROCESS (1938) (regarding expertise); William E. Scheuerman, LIBERAL DEMOCRACY AND THE SOCIAL ACCELERATION OF TIME 124 (2004) (regarding flexibility).

separation of powers commitments.¹⁶⁵ Although the pairing of expertise and discretion is desirable in the first instance, it nonetheless raises anxieties over agencies' accountability, legitimacy, and reasoned decision-making.¹⁶⁶ In order to assuage those concerns, agency discretion is hemmed-in by a byzantine patchwork of constraints—imposed variously by Congress, the federal judiciary, and from within the executive branch hierarchy itself.¹⁶⁷

Policymaking by regulatory agencies is most often associated with a specific legal mechanism, notice-and-comment rulemaking, which is the closest administrative analogue to Congressional legislation.¹⁶⁸ But there is no legal basis for prioritizing that particular procedure. A foundational doctrine of administrative law, known as the *Chenery* principle, holds that agencies have discretion to rely on whichever policymaking vehicle they prefer.¹⁶⁹ That doctrine opens up a broad menu of procedural fora, which is jointly defined by the “organic” statute that Congress uses to delegate its authority to an agency, along with the Administrative Procedure Act (APA), which applies across statutes. The full range of agency actions that follow can be reduced to three categories: rulemaking (with formal and informal variants); adjudication (also with formal and informal variants); and enforcement (through claims brought either in administrative or federal court).

At first glance, the *Chenery* choice-of-forum principle threatens the equilibrium of discretion and constraint that underpins the standard model of agency decision-making. That balance is nonetheless maintained, however, in light of two tradeoffs that tend to apply across the different forms of regulatory policymaking. The first is a “formality-review” tradeoff. When agencies elect to use relatively “formal” decision-making procedures to set policy—in other words, methods that impose a greater burden on the agency because they are more deliberative, participatory, or transparent to outside observers—those decisions receive less judicial scrutiny. This tradeoff is explicitly introduced by judicial doctrines that determine which standards of review (for example, *Chevron* or *Skidmore* deference) apply to which agency actions.¹⁷⁰ It also arises through a more subtle process, in which courts apply seemingly identical legal tests—such as the arbitrary-and-capricious standard—more or less stringently depending on the procedural context

¹⁶⁵ See generally M. Elizabeth Magill, *Beyond Powers and Branches in Separation of Powers Law*, 150 U. PA. L. REV. 603 (2001); see also Adrian Vermuele, *LAW'S ABNEGATION: FROM LAW'S EMPIRE TO THE ADMINISTRATIVE STATE* 56-74 (2016); LANDIS, *supra* note 164, at 46.

¹⁶⁶ See Lisa Bressman, *Beyond Accountability: Arbitrariness and Legitimacy in the Administrative State*, 78 N.Y.U. L. REV. 461 (2003).

¹⁶⁷ Because the executive power that Article II purports to lay out is more or less missing, the history of administrative law is largely the story of how the varying source and strength of those constraints has been improvised over time. See generally Jerry L. Mashaw, *CREATING THE ADMINISTRATIVE CONSTITUTION: THE LOST ONE HUNDRED YEARS OF AMERICA ADMINISTRATIVE LAW* (2012).

¹⁶⁸ See Stewart, *supra* note 10, at 444.

¹⁶⁹ *Chenery II*, *supra* note 14; cf. *NLRB v. Bell Aerospace*, 416 U.S. 267 (1974) (affirming *Chenery II*).

¹⁷⁰ See Thomas W. Merrill & Kristen E. Hickman, *Chevron's Domain*, 89 GEO. L. J. 833 (2001).

in which an agency has acted.¹⁷¹ The overall effect is that agency avoidance of *ex ante* (procedural) constraints is offset by greater *ex post* (judicial) constraints.¹⁷²

The second principle that applies across forms of administrative policymaking is a “substance-discretion” tradeoff, in which agency decisions that have a greater influence over substantive policy receive more scrutiny from other governmental actors. Agencies can influence the substance of policy by either adopting statutory interpretations that are relatively bold compared to plausible textual alternatives, or by intervening in issue areas that are of major significance to public policy.¹⁷³ When they do so, more intensive review will follow through one of two mechanisms. First, there is the so-called “strategic substitution effect,” which means that when agencies undertake ambitious policy decisions they will preemptively adopt more formal procedures in order to survive subsequent levels of review.¹⁷⁴ Second, a number of supplemental constraints—which may include judicial doctrines, executive branch protocols, or congressionally-mandated procedures—are triggered when agencies decide to aggressively push the direction of policy. In short, the substance-discretion tradeoff means that when agencies make more vigorous use of policy delegations, that latitude is counterbalanced by additional *ex post* or *ex ante* constraints.

To be sure, the one constant in administrative law is endless doctrinal caveats and a general over-complexity. The two dynamics sketched above therefore represent systemic patterns, rather than iron laws. Yet they are sufficiently widespread that scholars have been motivated to search out genres of agency “unorthodoxy,” where the normal balance of legal constraint does not apply. The two most prominent cases, mentioned in the Introduction, are the regulation of emergencies and executive inaction.¹⁷⁵ A good example of the latter is the Obama administration’s choice to refrain from applying portions of the federal drug laws that relate to marijuana.¹⁷⁶ That decision evades the formality-review tradeoff, because it was promulgated through a handful of informal policy statements and DoJ memoranda yet managed to sidestep judicial scrutiny under cover of the *Heckler v. Chaney* doctrine—which holds that the executive’s decision to *not* enforce the law cannot (in most cases) be reviewed by the courts.¹⁷⁷ At the same time, the Obama administration’s decision also eludes the Substance-Discretion Tradeoff, since it fundamentally altered the substance of federal anti-drug policy without being subject to the checks that would have accompanied analogous alternatives, such as a massive revision to the federal sentencing guidelines governing the sale or possession of marijuana.

¹⁷¹ Magill, *supra* note 16, at 1440-41. David Zaring, *Reasonable Agencies*, 96 VA. L. REV. 135 (2011).

¹⁷² Cass Sunstein has labelled this tradeoff the “pay now or pay later” principle. Sunstein, *supra* note 16, at 225-26; *see also* VERMUELE, *supra* note 165, at 81; Seidenfeld, *supra* note 160

¹⁷³ Magill, *supra* note 16, at 1414.

¹⁷⁴ *See* Stephenson, *supra* note 17; Magill, *supra* note 16, at 1442.

¹⁷⁵ *See* Notes 3, 4, & 5, *supra*.

¹⁷⁶ *See generally*, Bradley E. Markano, *Enabling State Deregulation of Marijuana Through Executive Branch Nonenforcement*, 90 N.Y.U. L. REV. 289 (2015).

¹⁷⁷ *Heckler v. Chaney*, 470 U.S. 821 (1985).

With regulation by settlement, a new form of agency unorthodoxy has emerged. Although this Article focuses on that development within the financial regulation context, the rise of regulatory settlements is significant for administrative law as a whole. One reason is that—despite the habit of scholarship on the subject to draw its source material from agencies that are responsible for environmental, health, or safety regulation—there is a growing appreciation that financial regulation is the quintessential administrative law field.¹⁷⁸ In addition, a recent influx of landmark agency-firm settlements in other areas, such as the automotive and pharmaceutical industries, suggests that regulation by settlement may be migrating to other portions of the administrative state as well.¹⁷⁹

B. Regulation by Settlement versus Standard Forms of Agency Policymaking

The best way to understand the uniquely unconstrained quality of regulation by settlement is through a close comparison between that practice and the more conventional modes of regulatory policymaking: administrative rulemaking, adjudication, and enforcement. The discussion below undertakes that examination by touring a broad and somewhat technical range of administrative law doctrines. A clear pattern emerges in the process. While the dual tradeoffs of regulatory policymaking (formality-review and substance-discretion) consistently apply across the full menu of agency actions, they prove to be entirely inapplicable to regulation by settlement. As a result, regulation by settlement slips free of the balance of constraint and discretion that is otherwise maintained for both formal and informal agency policymaking forms.

i. Rulemaking

The APA technically designates a particular “formal” rulemaking procedure, but it is almost never used.¹⁸⁰ Instead, the most formal rulemaking that actually takes place is performed pursuant to the notice-and-comment (n&c) procedures laid out in APA Section 553. That provision requires agencies to undertake three steps when promulgating a regulatory rule: (1) publish a notice of proposed rulemaking in the Federal Register; (2) allow interested parties the opportunity to comment on the proposal; and (3) provide a response that considers the comments that have been made.¹⁸¹ In addition to the APA’s requirements, n&c rulemaking is further constrained by a review process that takes place within the executive branch—overseen by the President’s Office of Management Budget (OMB) and its subsidiary department, the Office of Information & Regulatory Affairs (OIRA)—which

¹⁷⁸ See Notes 20 & 21, *supra*.

¹⁷⁹ Cf. William Yeatman, *Executive Lawmaking in EPA-Justice Department-Volkswagen Settlement*, YALE J. REG. ONLINE (Oct. 31, 2016); U.S. DEP’T OF JUSTICE, Release No. 11-1665, *Justice Department Recovers \$3 Billion in False Claims Act Cases in Fiscal Year 2011* (Dec. 19, 2011) (detailing recent FCA settlements with pharma companies).

¹⁸⁰ 5 U.S.C. § 553(c) (providing conditions that require formal rulemaking); *see. United States v. Florida E. Coast Railway*, 10 U.S. 224 (1973) (interpreting the APA triggers narrowly).

¹⁸¹ 5 U.S.C. § 553(b)-(c).

requires that an agency submit a detailed cost-benefit analysis of its proposed rule for OIRA approval before that rule can be finalized.¹⁸² Regulations that are finalized through the n&c process are considered “legislative rules,” meaning that they carry the “force of law” in the same way that a Congressional statute does.¹⁸³

Agencies also have an inherent authority to engage in rulemaking outside of the n&c process, by issuing what Section 553 of the APA refers to as “interpretive rules” or “statements of policy.”¹⁸⁴ Agencies frequently take advantage of this exception from the more formal n&c procedures to issue a wide array of documents, which are collectively known by shorthand as “guidance.”¹⁸⁵ The regulatory standards set forth in agency guidance usually constitute “nonlegislative rules,” which lack the freestanding legal authority of n&c rules.¹⁸⁶ The “nonlegislative” label captures the presumption that guidance documents concern comparatively minor matters of procedure or interpretation, which are interstitial to the more robust legal mandates that are promulgated in statutory provisions or legislative rules.

The Formality-Review Tradeoff

The choice that agencies face when deciding whether to engage in n&c rulemaking or instead release guidance reflects the formality-review tradeoff. The clearest example concerns the standard of review that applies to agency rules that resolve questions of law. In its influential *Mead* opinion,¹⁸⁷ the Supreme Court endorsed the (rough) rule of thumb that agencies’ statutory interpretations should receive *Chevron* deference in connection with judicial review of n&c rules,¹⁸⁸ while review of agency guidance should be subject to the much more limited *Skidmore*

¹⁸² The OMB-OIRA review process was established by a series of Executive Orders that date back to the Reagan administration. *See generally* Cass R. Sunstein, *The Office of Information and Regulatory Affairs: Myths and Realities*, 126 HARV. L. REV. 1838 (2013). The EOs technically do not apply to independent agencies, but those agencies are informally pressured to comply. *Id.* at n.5.

¹⁸³ For the notoriously complex scholarly debate over the precise contours of the “legislative rules” category, *see* David L. Franklin, *Legislative Rules, Nonlegislative Rules, and the Perils of the Short Cut*, 120 YALE L. J. 276 (2010); Jacob E. Gersen, *Legislative Rules Revisited*, 74 U. CHI. L. REV. 1705 (2007); John F. Manning, *Nonlegislative Rules*, 72 GEO. WASH. L. REV. 893 (2004).

¹⁸⁴ 5 U.S.C. 553 § 553(b)(3)(A).

¹⁸⁵ *See generally* Nina A. Mendelson, *Regulatory Beneficiaries and Informal Agency Policymaking*, 92 CORNELL L. REV. 397 (2007) (providing an overview of guidance); Robert A. Anthony, *Interpretive Rules, Policy Statements, Guidance, Manuals, and the Like—Should Federal Agencies Use Them to Bind the Public?* 41 DUKE L. J. 1311 (1992) (same).

¹⁸⁶ The practical consequence is that, when bringing an enforcement action in court, agencies may invoke violation of a legislative rule as the legal basis for taking action against a regulated party, but may not do the same for nonlegislative rules.

¹⁸⁷ *Mead*, *supra* note 16.

¹⁸⁸ *Chevron, U.S.A. v. Natural Res. Def. Council*, 467 U.S. 837 (1984). The precise meaning of *Chevron* deference has spawned endless debated, but the basic proposition is that courts must defer to any reasonable interpretation that any agency adopts with regard to ambiguous statutory language. *See* Matthew Stephenson & Adrian Vermeule, *Chevron Has Only One Step*, VA. L. REV. 597 (2009).

standard of deference.¹⁸⁹ The rule in *Mead* is subject to many caveats and complications, but the general thrust in this area of the law is that, for pure legal questions, judicial deference is positively correlated with administrative formality.¹⁹⁰

Another case where the tradeoff arises concerns judicial review of agency actions pursuant to the arbitrary-and-capriciousness (a&c) requirement found in Section 706(a)(2) of the APA.¹⁹¹ The classic explanation of a&c review, also known as the “hard look” doctrine, appears in the Court’s *State Farm* opinion, which states that an agency is required to “examine the relevant data and articulate a satisfactory explanation for its action including a ‘rational connection between the fact found and the choice made.’”¹⁹² Although in theory the same a&c standard applies to all forms of agency rulemaking, the hard look doctrine indirectly favors legislative over nonlegislative rules. That is because the quasi-procedural nature of the test articulated in *State Farm*—which demands that agencies “articulate a satisfactory explanation” for their decisions—maps on to the elaborate reason-giving procedures that are already incorporated in n&c requirements.¹⁹³

Regulatory settlements are less formal than the agency rulemaking process, no matter how it is conducted. The clearest contrast is with n&c rulemaking. Agencies regularly spend multiple years preparing a single n&c rule, during which time they produce thousands of pages of documentation that expose the underlying policy rationale to scrutiny from the public, Congress, the executive, and the courts.¹⁹⁴ Settlements, on the other hand, are crafted through bilateral negotiations between agencies and firms. The substance of those negotiations is kept confidential from the public, and they are conducted without being subject to any APA-mandated procedures or systematic oversight by the OMB.¹⁹⁵ Once deals are struck, they are memorialized by writings that take a variety of formats, but in many cases consist

¹⁸⁹ *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944). When applying *Skidmore* deference, courts need only consult an agency’s interpretation to the extent that it is well-reasoned or otherwise persuasive. See Sunstein, *supra* note 16, at 211.

¹⁹⁰ See *Christensen v. Harris Cnty.*, 529 U.S. 576, 587 (2000) (injecting some ambiguity into the *Mead* precedent); *Barnhart v. Walton*, 535 U.S. 212 (2002) (same); Lisa Schultz Bressman, *How Mead Has Muddled Judicial Review of Agency Action*, 58 VAND. L. REV. 1443 (2006).

¹⁹¹ 5 U.S.C. § 706(a)(2).

¹⁹² *Motor Vehicles Manufactures Ass’n v. State Farm*, 463 U.S. 29, 43 (1983); see also *Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 402 (1971).

¹⁹³ Thus, if an identical policy position is expressed in both an n&c rule and a guidance document, the former is less likely to be vacated on a&c grounds. See Magill, *supra* note 16, at 1390-91.

¹⁹⁴ Cf. Thomas O. McGarity, *Some Thoughts on “Deossifying” the Rulemaking Process*, 41 DUKE L. J. 1385 (1992); Mathew D. McCubbins, Roger G. Noll & Barry R. Weingast, *Administrative Procedures as Instruments of Political Control*, 3 J. L. ECON. & ORG. 243, 254 (1987).

¹⁹⁵ But see Farber & O’Connell, *supra* note 3, at 1172-73 (speculating that there may be OMB signoff on some settlements).

of a handful of pages that cover the barest of factual allegations and assert boilerplate legal conclusions.¹⁹⁶

Regulatory settlements are less formal than guidance documents as well. For one, the APA calls for certain categories of guidance to be published in the Federal Register.¹⁹⁷ It also includes a petition procedure that entitles stakeholders to request the “issuance, amendment, or repeal” of any guidance, and requires agencies to provide a reasoned written-response.¹⁹⁸ Perhaps most important is the relative levels of transparency. Guidance documents necessarily represent an official, explicit statement of agency policy. In contrast, the “rule” produced through regulation by settlement is implicit, and consists of the precedential signal that is cobbled together through a body of interrelated settlement agreements. As a result, the policy that is embedded in regulatory settlements is less observable to third parties (and therefore less vulnerable to criticism).¹⁹⁹

Regulatory settlements are also subject to more limited judicial review than either legislative or nonlegislative rules. The most extreme example is non-prosecution agreements (NPAs), which are concluded through agency “letters” that cannot be challenged in court on any grounds.²⁰⁰ With deferred prosecution agreements (DPAs), a charging document is filed in federal court but is accompanied by a settlement agreement, in which the DoJ commits—subject to the court’s approval—to withhold trial on the pending charges and to dismiss them completely after a specified period if the defendant corporation complies with certain conditions.²⁰¹ Judicial approval of DPAs is generally a mechanical, automatic process.²⁰² In 2015, when a DPA was rejected by a federal judge for the first time ever, the D.C. Circuit unanimously reversed, explaining that courts have no authority to second-guess the substantive merits of DPAs in any respect, and may only intervene to deter prosecutorial harassment of defendants.²⁰³

The same general exclusion of meaningful substantive or procedural review also applies to regulatory settlements based on civil claims, which are typically styled as consent orders and filed simultaneously with a civil complaint before a

¹⁹⁶ See Koehler, *FCPA Enforcement*, *supra* note 54, at 528 (making this point with respect to NPAs and DPAs).

¹⁹⁷ 5 U.S.C. § 552(a) (providing a “publication requirement,” which applies to agency guidance that takes the form of interpretive rules or policy statements).

¹⁹⁸ *Id.* § 553(e); see Mendelson, *supra* note 185, at 440-41. It is also common for agencies to voluntarily invite interest groups to consult on informal rules as they are being developed. *Id.* at 528.

¹⁹⁹ Some suggestive evidence on this point is the DoJ and SEC’s apparent reluctance to issue comprehensive guidance on their FCPA enforcement practices, despite being subject to years of questioning over the policy decisions reflected in corporate anti-corruption settlements. See Koehler, *Grading the FCPA Guidance*, *supra* note 81.

²⁰⁰ See Garrett, *supra* note 9, at 928.

²⁰¹ *Id.*

²⁰² See U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-10-110, CORPORATE CRIME 25 (2009) (finding that “judges reported they were essentially not involved in the DPA process”).

²⁰³ *United States v. Fokker Services B.V.*, No. 15-3016 (D.C. Cir. 2016) (reversing *United States v. Fokkers Servs. B.V.*, 79 F. Supp. 3d 160, 166 (D.D.C. 2015); cf. *United States v. HSBC Bank USA*, No. 12-CR-763 (E.D.N.Y. July 1 (2013)).

federal court or administrative tribunal.²⁰⁴ As with DPAs, the applicable standard of review for civil regulatory settlements was also recently highlighted by an emphatic appellate reprimand—in this instance a unanimous Second Circuit reversal of Judge Rakoff’s decision to withhold approval of one of the Securitization Settlements, between the SEC and Citigroup.²⁰⁵ There, the Second Circuit made clear that civil settlements, including those that seek to further “the public interest” through various forms of injunctive relief, can only be rejected by courts in the event that they fail to meet basic procedural thresholds for legality, intelligibility, or prosecutorial misconduct.²⁰⁶ In sum, for all forms of regulatory settlements, regardless of their particular procedural posture, the scope of judicial review is sharply circumscribed relative to any of the standards that are applicable in the rulemaking context.

The formality-review tradeoff holds across different forms of rulemaking. When regulation by settlement is considered alongside n&c rulemaking and agency guidance, however, it turns out to be both the least formal and least reviewable of all three agency actions. That leads to some curious outcomes in the financial regulation context, where Dodd-Frank has made n&c rulemaking the predominant policymaking tool.²⁰⁷ For one, the disparate levels of formality effect the timing of regulation. The SEC concluded its earliest Securitization Settlements before Dodd-Frank was even passed in 2010. Meanwhile, six years later, over one-fifth of the rulemakings that the SEC is required to issue under Dodd-Frank have yet to be finalized.²⁰⁸ Such divergent timelines would make sense if the more deliberative approach taken with rulemaking yielded less *ex post* scrutiny. Instead, the opposite has occurred. An important SEC rule was struck down by the D.C. Circuit in its *Business Roundtable* decision, and that court has vacated one of the CFTC’s rules as well.²⁰⁹ By contrast, the Securitization Settlements have been granted perfunctory judicial approval in all but one instance, the *Citigroup* case, which was quickly reversed upon appeal.²¹⁰ With regulation by settlement, the formality-review tradeoff is turned upside down.

²⁰⁴ See *id.* Slip. Op. at 12 (scope of review is equivalent for consent orders and DPAs).

²⁰⁵ *SEC v. Citigroup Global Markets, Inc.*, 752 F.3d 285 (2d. Cir. 2014) (*reversing S.E.C. v. Citigroup Global Markets Inc.*, 827 F.Supp.2d 328 (S.D.N.Y. 2011)) [*hereinafter Citigroup*].

²⁰⁶ *Citigroup*, 732 F.3d at 332; see also *United States v. Microsoft Corp.*, 56 F.3d 1448, 1460-62 (D.C. Cir. 1995) (holding that the “public interest” criterion does not open up room for substantive judicial review).

²⁰⁷ See DAVIS POLK & WARDWELL, DODD-FRANK PROGRESS REPORT, Fourth Quarter 2014 (Jan. 1, 2015) (finding that Dodd-Frank mandates that regulatory agencies promulgate roughly 395 new administrative rules).

²⁰⁸ See Ian Cuillerier & Elizabeth A. Martinez, *Implementing Dodd-Frank: Current Status of SEC Mandatory Rulemaking*, WHITE & CASE (Sep. 23, 2016).

²⁰⁹ *Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011) (striking down SEC proxy access rule as arbitrary-and-capricious); *International Swaps and Derivatives Ass’n (ISDA) v. CFTC*, 887 F. Supp. 2d 259 (D.D.C. 2012); see also Jill E. Fisch, *The Long Road Back: Business Roundtable and the Future of SEC Rulemaking*, 36 SEA. U. L. REV. 695, 704 (2013) (analyzing the broader trend of recent “repeated invalidations of SEC rulemakings”).

²¹⁰ See *Citigroup*, *supra* note 205, at 289.

The Substance-Discretion Tradeoff

When agencies undertake rulemaking they are subject to the substance-discretion tradeoff through a number of mechanisms. One of the most direct devices is the Supreme Court’s “major questions” doctrine, recently applied in its review of the Affordable Care Act, which stands for the principle that agency statutory interpretations will not receive *Chevron* deference if they resolve questions of great national importance.²¹¹ As agencies raise the policy stakes, courts tighten *ex post* constraints to compensate. Another relevant tool involves statutory provisions that direct agencies to address certain legal issues through n&c rulemaking, and often further require that those rules be finalized by pre-specified deadlines. That tactic, which Congress used to an unprecedented extent in Dodd-Frank, shuts the door on the opportunity for agencies to rely on guidance to resolve policy decisions that are considered sensitive by Congress.²¹²

A more subtle source of the substance-discretion tradeoff arises from the strategic substitution effect: when developing relatively significant or innovative regulatory policies, agencies have an incentive to voluntarily shift from guidance to rulemaking in order to safeguard those decisions with more deferential judicial review.²¹³ Less risk-averse agencies, on the other hand, may adopt the opposite strategy, and attempt to rely on guidance as a way to smuggle significant policy decisions under the n&c radar.²¹⁴ One roadblock such an approach will run into is put in place by Executive Orders that mandate OIRA review for any agency action that produces a “significant” rule, regardless of whether a rule is nominally packaged as guidance.²¹⁵ A further hurdle is introduced by “procedural review” of guidance, a judicial doctrine that empowers courts to invalidate any agency rule that purports to be nonlegislative guidance but in substance resembles the broad policy positions that are characteristic of legislative rules.²¹⁶ Taken together, this pair of executive

²¹¹ *King v. Burwell*, 576 U.S. __, Slip. Op. at 8 (2015); see also *Utility Air Regulatory Group v. EPA*, 573 U.S. __ (2014); *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 132-33, 159-61 (2000); cf. Sunstein, *supra* note 16, at 193 (discussing the doctrine).

²¹² Jacob E. Gersen, *Administrative Law Goes to Wall Street: The New Administrative Process*, 65 ADMIN. L. REV. 689 (2013).

²¹³ Stephenson, *supra* note 17, at 530-31. Empirical studies find that guidance documents usually tackle smaller issues, which suggests that the strategic substitution effect is a pervasive influence. Connor Raso, *Strategic or Sincere? Analyzing Agency Use of Guidance Documents*, 119 YALE L. J. 782, 821-22 (2010).

²¹⁴ See, e.g., Jennifer Nou, *Agency Self-Insulation Under Presidential Review*, 126 HARV. L. REV. 1755 (2013); Bryan Clark & Amanda C. Leiter, *Regulatory Hide and Seek; What Agencies Can (and Can’t) Do to Limit Judicial Review*, 52 B.C. L. REV. 1687 (2011).

²¹⁵ A rule will be categorized as “significant” if it estimated to have an “annual effect on the economy of \$100 million” or if it “raises novel legal or policy issues.” Exec. Order No. 12,866, 3 C.F.R. 638 (1994); Exec. Order No. 13,422, 72 Fed. Reg. 2763 (Jan. 23, 2007).

²¹⁶ The logic is that, once guidance is unmasked as a *de facto* legislative rule, it automatically follows that it is procedurally defective for failing to comply with the n&c process. See Mark Seidenfeld, *Substituting Substantive for Procedural Review of Guidance Documents*, 90 TEX. L. REV. 331, 360-61 (2011); David Franklin, *Two Cheers for Procedural Review of Guidance Documents*, 90 TEX. L. REV. 111, 120 (2012); see, e.g., *Appalachian Power Co. v. EPA*, 208 F.3d 1015, 1020 (D.C. Cir. 2000); *Community Nutrition Institute v. Young*, 818 F.2d 943 (D.C. Cir. 1987).

and judicial safeguards limits an agency's chances of skirting the substance-discretion tradeoff through the opportunistic use of guidance.

The substance-discretion tradeoff thus permeates the incentives that agencies face when deciding whether to shift between rulemaking forms. Regulation by settlement, by contrast, avoids those same dilemmas in dramatic fashion. As each of the three case studies show, regulatory settlements have been used to establish *de facto* legal standards that are bolder than what is provided by related statutory or administrative rules: the FCPA Settlements stake out more extreme policy positions than those that are found in the FCPA Guidance; the Securitization Settlements reflect a theory of liability that goes far beyond Dodd-Frank's disclosure and due diligence reforms in the same area; and, the Benchmark Settlements impose a broader prohibition on financial market manipulation than was provided in parallel CFTC regulations, both before and after Dodd-Frank.²¹⁷ At the same time, relative to regulatory settlements, agency rulemaking is subject to more intensive oversight on all fronts—from Congress, the courts, the Executive Office of the President, and the public.

A hypothetical comparison between agency guidance and regulatory settlements drives this point home. Assume that the implicit rule created by the Securitization Settlements was instead formulated as a guidance document—call it, the “Securitization Interpretive Rule.” Pursuant to the APA, the relevant legal standard would be articulated in express terms (e.g. “banks shall be liable for negligent securitization practices”), published in the Federal Register, and subject to public petition requests thereafter. The Securitization Interpretive Rule would easily qualify as a “significant” rule—\$50 billion in settlement penalties satisfies the applicable \$100 million annual impact requirement for 500 consecutive years—and therefore fall under the executive branch requirements for formal cost-benefit analysis and OIRA review. If it satisfied the OIRA process, the Securitization Interpretive Rule might then face a “procedural review” challenge in federal court, and potentially be vacated on the grounds that it is a defective nonlegislative rule. If the Securitization Interpretive Rule survived procedural review, and was eventually put at issue in a subsequent enforcement action against a regulated party, it would then undergo a second round of judicial scrutiny, pursuant to the *a&c* hard look doctrine as well as the minimally deferential *Skidmore* standard.²¹⁸

There is a strain of administrative law scholarship that regards guidance with suspicion, and the business law literature is even more quick to condemn “regulation by guidance” as an unacceptably informal way to make policy “through the back door.”²¹⁹ But everything is relative. Compared to regulation by settlement, guidance

²¹⁷ See Section II.B, *supra*.

²¹⁸ The latter inquiry in particular would be a hard sell, given the government's lack of success in analogous financial crisis litigations. See Section II.B.ii.

²¹⁹ Pierce, *supra* note 152 (criticizing CFTC guidance as backdoor policymaking); *but cf.* Donna M. Nagy, *Judicial Reliance on Interpretations in SEC No-Action Letters*, 83 CORNELL L. REV. 921 (1998) (explaining how certain expressions of SEC policy can slip through the procedural cracks that normally govern interpretive statements and other guidance documents).

is a staple of the agency policymaking toolkit, is predictably conservative in scope, and is constrained by an array of well-established procedural safeguards.

ii. *Adjudication*

Agencies act in an adjudicative capacity when issuing orders that resolve legal questions concerning particularized parties.²²⁰ Under the *Chenery* principle, agencies are free to use those same decision-making procedures to announce new policies of general applicability.²²¹ Prior to the ascendance of n&c rulemaking, the historical norm was for agencies to develop regulatory rules through adjudicative proceedings, and a few agencies continue to maintain that practice.²²²

Administrative adjudications are conducted with varying degrees of formality. The APA requires that agencies are required to adopt “formal” adjudicative procedures whenever the applicable organic statute calls for a “hearing on the record.”²²³ Formal adjudications include oral argument before an independent Administrative Law Judge (ALJ), along with many of the procedural amenities that are attendant to litigation in federal court.²²⁴ Where an organic statute does not contain the relevant triggering language, the APA allows agencies to engage in “informal” adjudication.²²⁵ Agencies are free to conduct informal adjudications through as minimal a process as they deem reasonable,²²⁶ but in practice those proceedings tend to incorporate some form of “paper hearing” and are resolved by the decision of a neutral Administrative Judge (AJ) (a variant on the ALJ position).²²⁷

The Formality-Review Tradeoff

Judicial doctrines that govern the formality-review tradeoff in the rulemaking context apply to an agency’s choice of formal versus informal

²²⁰ See 5 U.S.C. § 551(7); *Bi-Metallic Investment Co. v. State Bd. Of Equalization*, 239 U.S. 441, 445-46 (1915); see also David L. Shapiro, *The Choice of Rulemaking or Adjudication in the Development of Administrative Policy*, 78 HARV. L. REV. 921, 924 (1965).

²²¹ *Chenery II*, *supra* note 14; see Shapiro, *supra* note 220, at 925-27.

²²² See Daniel R. Ernst, *TOCQUEVILLE’S NIGHTMARE: THE ADMINISTRATIVE STATE EMERGES IN AMERICA, 1900-1940* (2014) (tracing formative efforts to constrain the policymaking capacity of agency adjudications). Contemporary adjudication-centric agencies include The National Labor Relations Board, the Bureau of Immigration Affairs, and, to a slightly less extent, the Federal Trade Commission. See, e.g., Mark H. Grunewald, *The NLRB’s First Rulemaking: An Exercise in Pragmatism*, 41 DUKE L.J. 274, 274 (1991).

²²³ 5 U.S.C. §§ 554(a).

²²⁴ *Id.* §§ 554, 556-558 (providing procedural requirements for formal adjudications). One major departure from federal trial practice is that hearsay and other exclusionary rules in the Federal Rules of Evidence do not apply in agency adjudications.

²²⁵ *Id.* § 555.

²²⁶ *Pension Benefit Guarantee Corp. v. LTV Corp.*, 496 U.S. 633 (1990); see also *Vermont Yankee Nuclear Power Corp. v. N.R.D.C.*, 435 U.S. 519 (1978).

²²⁷ See Paul Verkuil, *A Study of Informal Adjudication Procedures*, 43 U. CHI. L. REV. 739 (1976). The putative “independence” of ALJs and AJs might seem to limit the policymaking potential of administrative adjudications, but it does not do so in practice because senior agency officials have effectively unlimited discretion to revise the legal conclusions and findings of fact that are contained in an initial adjudicative decision. 5 U.S.C. § 557(b).

adjudications. For questions of law, the *Mead* rule controls and calls for federal courts to apply *Chevron* deference to agency statutory interpretations announced in formal adjudications while applying the stricter *Skidmore* standard in informal adjudications.²²⁸ “Hard look” a&c review also applies to all forms of agency adjudication. As in the case of rulemaking, the a&c standard provides an implicit gradient of deference between formal and informal adjudications due to the more thoroughgoing deliberation that is built into the formal hearing process. The same may also be said of judicial review of agencies findings of fact, where a nominally distinct pair of standards—“substantial evidence” in formal proceedings; arbitrary-and-capricious review for informal adjudications—are widely recognized as indistinguishable in practice.²²⁹ Because the structure of formal adjudications will generate more comprehensive evidentiary records than is the case for informal adjudications, applying a common evidentiary threshold to both procedures leaves the latter on a more secure footing.

Regulatory settlements entail less legal formality than either variety of adjudication. On one level the distinction holds almost as a matter of definition: even the most barebones informal adjudication concludes with a legal determination on the merits, while settlements are quasi-contractual negotiations that result in agreements-not-to-agree. The contrast becomes more concrete with respect to formal adjudications. There, ALJs oversee elaborate adversarial procedures that resemble a full civil trial, and justify the agency’s disposition of the case with detailed opinions that are comparable in sophistication to those issued by federal circuit court judges.²³⁰ A final distinction turns on the publicness of agency adjudication. While settlements are purely bilateral, judicial doctrines have grafted broad intervenor rules onto the APA’s requirements for formal adjudications, which facilitates direct stakeholder participation in those proceedings.²³¹

The scope of judicial review for regulatory settlements is also narrower than any standard that is applicable to formal or informal agency adjudications, including the substantial evidence test.²³² The doctrinal differences are not just semantic and can be seen in outcomes. Empirical studies indicate that findings of fact in administrative adjudications are regularly overturned by federal courts.²³³ So too are adjudicative determinations of law, with a notable recent example being the D.C.

²²⁸ *Mead*, *supra* note 16, at 230-31.

²²⁹ 5 U.S.C. § 706(2)(E) (providing the substantial evidence standard); *see NLRB v. Universal Camera Corp.*, 340 U.S. 474, 478-79 (1951) (explaining substantial evidence); *Ass’n of Data Proc. Serv. Org’s v. Bd. of Governors*, 745 F.2d 677, 683 (D.C. Cir. 1984) (holding that the two standards are functionally identical).

²³⁰ *See* Note 224, and accompanying text. According to one study, the average opinion of SEC ALJs contains a comprehensive recitation of the relevant factual findings, legal analysis and choice of remedy, and is similar in length and complexity to securities law opinions issued in the Second Circuit. *See* David Zaring, *Enforcement Discretion at the SEC*, 94 TEX. L. REV. 1155 (2015).

²³¹ *See* Magill, *supra* note 16, at 1433.

²³² As the Second Circuit held in reversing Judge Rakoff’s rejection of the Citigroup settlement, the legal standard for court approval of an agency settlements does not require those agreements to meet any level of factual sufficiency. *See Citigroup*, *supra* note 205.

²³³ *See* Zaring, *Reasonable Agencies*, *supra* note 171.

Circuit’s reversal of a significant adjudicative order issued by Dodd-Frank’s Consumer Financial Protection Bureau.²³⁴ Thus, administrative adjudication reflects another area of agency policymaking where the formality-review tradeoff holds across both formal and informal procedures but does not reach regulation by settlement, which combines minimal formality with minimal review.

The Substance-Discretion Tradeoff

The most critical decision affecting the mode in which regulatory policy is produced is an agency’s choice between rulemaking and adjudication. With the “rulemaking revolution” that took place in the 1960s and 70s, that decision came to reflect the substance-discretion tradeoff operating on an historical scale. During those decades, a confluence of legal and non-legal changes caused agencies to shift to rulemaking as the dominant forum for issuing high-impact policy decisions.²³⁵ But as substantive policymaking migrated toward rulemaking, the courts improvised a set of constraints to follow.²³⁶ The result is that, since administrative rules became the engine of executive policymaking, the n&c process has been “ossified” by the imposition of multi-year procedural hurdles, and the overall equilibrium of agency discretion and constraint remains in place.²³⁷

The substance-discretion tradeoff can also be seen at work along a number of dimensions with respect to agencies’ use of formal versus informal adjudication. First, as a result of the strategic substitution effect, agencies frequently layer procedural formalities onto informal adjudications, although the APA does not require them to do so.²³⁸ Second, the Supreme Court’s caselaw on constitutional due process includes doctrines that require agencies to provide enhanced procedural protections in adjudications where a significant deprivation of liberty or denial of access to important public goods is at stake.²³⁹ Third, Section 554 of the APA enables Congress to tailor the formality of adjudicative procedures to the significance of a given policy area, by triggering a requirement for formal adjudication whenever a statute supplies the relevant “hearing on the record” language.²⁴⁰

²³⁴ *PHH Corp. v. Consumer Financial Protection Bureau*, No. 15-117 (D.C. Cir. Oct. 11, 2016).

²³⁵ See Peter L. Strauss, *From Expertise to Politics: The Transformation of American Rulemaking*, 31 WAKE FOREST L. REV. 745 (1996); Reuel E. Schiller, *Rulemaking’s Promise: Administrative Law and Legal Culture in the 1960s and 1970s*, 53 ADMIN. L. REV. 1139 (2001); J. Skelly Wright, *The Courts and the Rulemaking Process: The Limits of Judicial Review*, 59 CORNELL L. REV. 375, 375-76 (1974).

²³⁶ In particular, a&c review was re-conceptualized with the hard look doctrine and the APA’s n&c provisions were interpreted in a way that gave those requirements surprising teeth. See Strauss, *supra* note 235.

²³⁷ See McGarrity, *supra* note 194.

²³⁸ See Verkuil, *supra* note 227.

²³⁹ See *Mathews v. Eldridge*, 424 U.S. 319 (1976); *Goldberg v. Kelley*, 397 U.S. 254 (1970). The constitutional due process caselaw can therefore be seen as an analogue to the “major questions” doctrine applied to rulemaking, but with administrative procedure serving as the supplementary constraint rather than heightened judicial review.

²⁴⁰ 5 U.S.C. § 554(a); *cf.* Gersen, *supra* note 212 (explaining how Congress now drafts statutes to obtain the same control in the rulemaking context).

With regulation by settlement, agencies have been systematically adopting bolder, more substantive policy positions in regulatory settlements than in adjudications. The case studies reflect a pattern that provides strong evidence on this point. In each case, agencies have largely hesitated to bring claims against individuals (in federal or administrative court) in connection with the same allegations that underpin million or billion dollar settlements with their employer firms; and in the rare instances when the agencies' legal theories do reach adjudication, they are quite often rejected on the merits.²⁴¹ Therefore, relative to agency adjudication, regulation by settlement evades the substance-discretion tradeoff—with less formality, less judicial review, and more progressive policymaking.

The preceding analysis is particularly relevant to financial regulation, where administrative adjudication is making a comeback. Under Dodd-Frank, administrative courts receive expanded subject matter jurisdiction and remedial authority for certain securities law claims, and the SEC has taken advantage of those reforms by relying more heavily on formal adjudications conducted in-house by its ALJs.²⁴² In doing so, the agency has sparked a firestorm of controversy in the business law press and scholarship, where SEC adjudications are characterized as dangerously illegitimate substitutes for litigation in federal court.²⁴³ These criticisms reflect a serious confusion over administrative law, as there is nothing irregular or unconstitutional about Dodd-Frank's marginal extension of adjudicative authority for financial regulators.²⁴⁴ The controversy itself is instructive, however. As with anxieties about "regulation by guidance," the outcry over SEC adjudication provides another case where an administrative mechanism is perceived to be regulatory discretion run wild, when in fact it fits comfortably within a well-defined network of constraints.

²⁴¹ See Section II.B, *supra*.

²⁴² See Dodd-Frank § 929(p), 15 U.S.C. § 78u-3 (expanding adjudicatory jurisdiction over certain securities fraud claims, including insider trading, and increasing limits on the SEC's civil fining penalties).

²⁴³ See, e.g., Giles D. Beal IV, *Judge, Jury, and Executioner: SEC Administrative Law Judges Post-Dodd Frank*, 20 N.C. BANK'G INST. 413 (2016); David Bario, *As the SEC Brings More Administrative Proceedings, Criticism Grows*, AMERICAN LAWYER (Feb. 26, 2015); Gretchen Morgenson, *Crying Foul on Plans to Expand the SEC's In-House Court System*, N.Y. TIMES (June 26, 2015).

²⁴⁴ Agency adjudication is the most historically-entrenched regulatory practice in American government, SEC ALJs render decisions pursuant to elaborate, Congressionally-mandated procedures that have been in place unchanged since 1946, and all findings of fact and law in those decisions are reviewable in federal court. See Zaring, *supra* note 230 (making the same general point); *but see* Gideon Mark, *SEC Enforcement Discretion*, 94 TEXAS LAW REVIEW 261 (2016) (providing a contrary view). Although constitutional challenges to SEC ALJs have very recently yielded a circuit split, neither of those cases stand for the proposition that the Dodd-Frank Act represents an impermissible extension of the SEC's adjudicative authority. Compare *Raymond J. Lucia Companies, Inc. v. SEC*, No. 15-1345 (D.C. Cir., Aug. 9, 2016) (rejecting all constitutional challenges) with *Bandimere v. SEC*, No. 15-9586 (10th Cir., Dec. 27, 2016) (holding that the SEC's procedures for selecting ALJs violates the Appointments Clause).

iii. Enforcement

The APA bifurcates the administrative process into either rulemaking or adjudication, and does not recognize “enforcement” as an equivalent form of agency action. Agencies nonetheless perform an enforcement function, which has distinct legal and conceptual features, and regulatory policy can be influenced by decisions regarding how that function is exercised.²⁴⁵ Regulatory settlements are a normal part of the administrative enforcement process but, as will be explained, regulation by settlement as a policymaking technique departs from conventional agency enforcement practices in significant ways.

An agency’s ability to initiate enforcement proceedings is determined by its organic statute, which may authorize actions in administrative court, federal court, or both. Where an agency is not entitled to bring a civil enforcement action directly, it can usually refer cases to the DoJ, which may litigate on the agency’s behalf.²⁴⁶ The internal deliberative process that an agency uses to determine whether to bring an enforcement action is not structured by any APA requirements and, under the *Heckler* prosecutorial discretion doctrine, those decisions are not reviewable in court outside of a few exceptional circumstances.²⁴⁷ Once an affirmative decision to enforce has been made, the primary procedural requirement is the “separation of personnel” rule provided in APA Section 554(d), which prohibits certain agency officials from simultaneously prosecuting an enforcement action and adjudicating its merits.²⁴⁸

Administrative law scholarship often fails to examine the agency enforcement function in isolation; instead, it tends to collapse enforcement into the adjudication side of the rulemaking versus adjudication paradigm.²⁴⁹ For purposes of understanding the constraints on administrative policymaking, that analytical move makes good sense under most circumstances. When narrowly construed, “enforcement” represents an intermediate procedural step—the decision to request that another governmental actor, a federal or administrative judge, consider taking some proposed action. It is therefore not a self-sufficient platform, like rulemaking or adjudication, from which an agency can make binding legal determinations or declare policy positions. From this perspective, there is little need to consider the policymaking dynamics of enforcement, because enforcement occupies a pre-policymaking phase in the administrative process. And, once an administrative enforcement proceeding has commenced, the familiar constraints applicable to agency adjudication come into play.

Enforcement also does not pose problems for the standard model of administrative policymaking when it is considered directly. Traditional

²⁴⁵ See generally Kate Andrias, *The President’s Enforcement Power*, 88 N.Y.U. L. REV. 1031 (2013).

²⁴⁶ See Michael Herz & Neal Devins, *The Consequences of DOJ Control of Litigation on Agencies’ Programs*, 52 ADMIN. L. REV. 1345 (2000).

²⁴⁷ *Heckler*, *supra* note 177.

²⁴⁸ 5 U.S.C. § 554(d). There are exceptions for higher-level agency decision-makers.

²⁴⁹ See Bijal Shah, *Uncovering Coordinated Interagency Adjudication*, 128 HARV. L. REV. 805, 827-28 (2015) (“[T]here are few (or no) satisfying definitions of agency enforcement that are cleanly divisible from adjudication.”); Magill, *Beyond Powers and Branches*, *supra* note 165.

administrative enforcement is entirely consistent, for example, with the substance-discretion tradeoff. On one hand, the enforcement decision involves less procedural formality or judicial review than rulemaking or adjudication. It therefore represents agency discretion at its high point. On the other hand, an enforcement decision is at best a form of agenda control,²⁵⁰ whereby agency personnel can “suggest” that an ALJ or federal judge adopt a new policy direction. That is a non-negligible source of influence, but much less impactful than what can be accomplished through rulemaking or formal adjudication. Thus, enforcement pairs maximal discretion with minimal substance, and the standard equilibrium holds.²⁵¹

Despite enforcement’s unassuming role within the broader menu of agency policymaking forms, “regulation by enforcement” is a prominent concept in the securities law scholarship, where the SEC’s influence over the law of insider trading is considered a paradigm case of the practice.²⁵² Analyses of regulation by enforcement often paint a picture of imbalanced policymaking due to prosecutorial discretion run amok.²⁵³ A review of the development of insider trading, however, indicates that regulation by enforcement is yet another area where consternation over allegedly deficient administrative procedure is largely misplaced.

The origins of modern insider trading law can be traced to a 1961 adjudicative decision by the SEC, *Cady Roberts*, which put a creative spin on the leading regulation governing securities fraud, known as Rule 10b-5.²⁵⁴ The particular trading prohibition announced in *Cady* was officially embraced by the courts in the Second Circuit’s *Texas Gulf Sulphur* decision of 1968.²⁵⁵ When the SEC and DOJ began to pursue more expansive enforcement theories in the early 1980s, the Supreme Court reversed those actions with a pair of landmark decisions, *Dirks* and *Chiarella*, which comprehensively re-wrote the legal framework for trading liability.²⁵⁶ Since then, insider trading law has evolved pursuant to an expansive body of federal common law which has micromanaged the applicable

²⁵⁰ See Thomas H. Hammond, *Agenda Control, Organizational Structure, and Bureaucratic Politics*, 30 AM. J. POL. SCI. 379 (1986).

²⁵¹ The substance-discretion tradeoff may also apply at the decisional level internal to enforcement: namely, whether to bring an enforcement action before an ALJ or in federal court. The SEC claims that it takes big, policy-relevant cases to federal court rather than to ALJs, on the grounds that federal trials provide more procedural formality. SEC. & EXCH. COMM’N, DIVISION OF ENFORCEMENT APPROACH TO FORUM SELECTION IN CONTESTED ACTIONS (2015).

²⁵² See Pitt & Shapiro, *supra* note 15; see also Anthony Barkow & Rachel Barkow, PROSECUTORS IN THE BOARDROOM (2011); Roberta Karmel, REGULATION BY PROSECUTION (1982); James J. Park, *The Competing Paradigms of Securities Regulation*, 57 DUKE L. J. 625 (2007).

²⁵³ A.C. Pritchard, *The SEC, Administrative Usurpation, and Insider Trading*, 69 STAN. L. REV. ONLINE 55, 60 (Oct. 3, 2016); Joan MacLeod Heminway, *Just Do It! Specific Rulemaking on Materiality in Insider Trading*, 72 LA. L. REV. 999 (2012).

²⁵⁴ *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961). 17 C.F.R. 240.10B-5; cf. *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 195 (1963) (affirming SEC policymaking through adjudication, *per* the *Chenery* principle).

²⁵⁵ *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (*en banc*).

²⁵⁶ *Chiarella v. United States*, 445 U.S. 222 (1980); *Dirks v. SEC*, 463 U.S. 643 (1983).

legal standards,²⁵⁷ the occasional Congressional intervention,²⁵⁸ and SEC rulemakings that are reactive to movements in the caselaw.²⁵⁹

The record reflects that the SEC’s enforcement priorities have played a role in insider trading law, but not one with greater influence than other regulatory tools, and certainly not a role which exceeds that of the courts. The ironic takeaway is that insider trading turns out to be a textbook example of the constrained and multi-faceted nature of administrative lawmaking, rather than a case of single-minded prosecutorial discretion gone wild.²⁶⁰ Although a comprehensive review of other areas where agency enforcement strategies play a prominent role in policy development—for example in antitrust regulation, or other parts of securities law—is beyond the scope of this article, the basic lesson provided by insider trading generally holds in those instances as well.²⁶¹ Thus, even during purported episodes of regulation by enforcement, the agency enforcement function represents a relatively conventional form of administrative policymaking.

There are two exceptional cases, however, where enforcement shifts from an orthodox to unorthodox mode of agency action. One is the familiar practice of non-enforcement through agency inaction.²⁶² Non-enforcement is able to upset the substance-discretion tradeoff that typically applies to agency enforcement by taking advantage of the agenda control aspect of the enforcement procedure with a highly

²⁵⁷ See Pritchard, *supra* note 253 at 60 (“The Court has not been satisfied to simply decide the [insider trading] case before it . . . [and] has ranged widely in defining the law of insider trading.”); Heminway, *supra* note 253, at 1007-08 (calling the applicable materiality test a “judicially constructed standard.”). For the most recent examples, see *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014); *Salman v. United States*, __ U.S. __, No. 15-628 (Dec. 6, 2016); cf. Stephen M. Bainbridge, *The Law and Economics of Insider Trading: A Comprehensive Primer* (2001) (reviewing the evolution of insider trading caselaw).

²⁵⁸ Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. No. 100-704, 102 Stat. 4677 (1988); Insider Trading Sanction Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (1984). Pritchard, *supra* note 253, at 62 (“Congress has at least ratified the idea of a common law insider trading prohibit by enacting legislation in 1984 and 1998 ramping up penalties for insider trading”).

²⁵⁹ The SEC finalized Rule 14e-3 in response to *Chiarella* and *Dirks*. 17 C.F.R. § 240.14e-3; 15 U.S.C. § 78n(e). The SEC’s most significant recent policymaking on insider trading consist of a disclosure rule known as “Reg. FD.” See 17 C.F. R. Sections 243.100-13 (2015).

²⁶⁰ See Magill, *supra* note 16 at n. 62 (making this same point).

²⁶¹ In the antitrust context, see William F. Baxter, *Separation of Powers, Prosecutorial Discretion, and the “Common Law” Nature of Antitrust Law*, 60 TEX. L. REV. 661, 686-87 (1982). Another notable episode of enforcement by the SEC took place in the early 2000s, when the agency worked in conjunction with efforts by Eliot Spitzer (then-NY attorney general) to bring prosecutions against the mutual fund industry. See BARKOW & Barkow, *supra* note 252. The SEC quickly retreated from the more aggressive tactics of that campaign, however, and a combination of regulatory rulemaking, guidance, and judicial review soon occupied the same policy space. See Park, *supra* note 22, at 154-55; Jonathan R. Macey, *Wall Street in Turmoil: State-Federal Relations Post-Eliot Spitzer*, 70 BROOK. L. REV. 117, 133 (2004) (arguing that Spitzer’s interventions in securities markets represented a “‘hostile takeover’ of the SEC, hijacking its agenda”).

²⁶² See Note 4, *supra*.

aggressive strategy of “negative agenda control.”²⁶³ By systematically excluding critical portions of the regulatory framework from the adjudicative phase where enforcement is given final effect, preexisting policy positions can be negated in a way that amounts to a new round of significant substantive policymaking. Since non-enforcement on such a scale is a fairly extreme measure, the most notable cases of agency inaction are usually the product of presidential high politics, as the marijuana example from the Obama administration suggests.²⁶⁴

Regulation by settlement represents a second strategy for destabilizing the standard substance-discretion balance of agency enforcement. With traditional agency enforcement, there may often be high settlement rates of 80 or 90 percent without the settlement process having any real impact on policy. The majority of cases which settle involve cookie-cutter issues that do not raise significant legal questions, and for the minority of enforcement actions that are premised on novel theories, defendants have an incentive to see the dispute through to adjudication on the merits. At that point, agency adjudication becomes the relevant policymaking forum, and the decision to announce progressive policies is up to the ALJ (or federal court judge). This is how insider trading law was launched, by an SEC adjudication that produced the *Cady* decision.²⁶⁵

Regulation by settlement only becomes possible in the post-2000s enforcement landscape, where a number of factors converge to make the settlement of corporate enforcement actions a foregone conclusion.²⁶⁶ As a result, enforcement is no longer an intermediate step that allows policies to be proposed to adjudicators. Instead, policymaking decisions occur directly in the enforcement phase, where actions that assert novel legal theories are associated with significant negotiated penalties as a matter of course. Under the conditions just described, settlement may still remain a low-stakes, idiosyncratic process that does not function as a significant policymaking vehicle. But regulation by settlement has emerged in recent years because, as the case studies provided above illustrate, agencies have decided to leverage the new dynamics of settlement to the greatest extent possible.²⁶⁷ In the process, federal agencies have managed to reshape the nature of financial regulation and administrative policymaking.

²⁶³ See Gary Cox & Matthew McCubbins, *SETTING THE AGENDA: RESPONSIBLE PARTY GOVERNMENT IN THE U.S. HOUSE OF REPRESENTATIVES* (2005) (analyzing the negative agenda control concept in the Congressional context).

²⁶⁴ See Markano, *supra* note 176; *but cf. United States v. Texas*, 579 U.S. __ (2016) (affirming 5th Circuit decision that rejected Obama administration’s non-enforcement of immigration laws).

²⁶⁵ See *Cady, Roberts*, *supra* note 254.

²⁶⁶ See Section II.A., *supra*.

²⁶⁷ One simple way to appreciate the impact of regulation by settlement is to compare the role of enforcement in the formation of insider trading law and anti-corruption law under the FCPA. In the former case, the SEC and DOJ’s enforcement strategies exerted a substantial but far from dominant influence. In the FCPA context, those agencies’ enforcement decisions have produced a body of settlements that swallow up the policy space completely.

IV. Normative Considerations & Policy Implications

This Section turns to the normative and prescriptive issues that are raised by the positive analysis of regulatory settlements presented above. Part A evaluates the strengths and weaknesses of regulation by settlement as a regulatory tool. Part B reviews the policy debate around regulatory settlements and suggests some limited reforms.

A. Evaluating Regulation by Settlement

A threshold point when considering the merits of regulation by settlement is that there is nothing inherently problematic about the settlement of legal disputes relative to resolution through adjudication. That is not necessarily the consensus view, and there is a long tradition of modest hostility toward settlement in the scholarship. The classic critique, by Owen Fiss, focused on the fact that settlement denied plaintiffs an opportunity to fully assert their legal rights and foreclosed public articulation of important social values by courts.²⁶⁸ More recently, anti-settlement sentiment has been revived and directed at regulatory settlements with a forceful twist. The main concern, voiced most prominently by Judge Rakoff, is that regulatory settlements typical take a “neither-admit-nor-deny” format, which allows defendants to avoid being associated with any official statement of wrongdoing, as would otherwise be forthcoming with a trial verdict or criminal guilty plea.²⁶⁹ While the prior critique emphasized judicial affirmance of positive rights, the contemporary argument recasts the point in more punitive terms, and calls for the public acknowledgement of legal culpability.

The classic rebuttal, equally applicable to both critiques, is that the institution of settlement redeems individuals’ private right to be free from legal conflict, and also promotes the public interest by ensuring efficient administration of the courts (in the context of civil litigation) and economizing on the scarce enforcement resources of the government (in the context of regulatory actions).²⁷⁰ There is also a further weakness, specific to Judge Rakoff’s line of argument. Any push for admissions of guilt is self-defeating in the current regulatory environment, because a defining feature of regulation by settlement is that agencies seek to hold firms liable on an across-the-board, industrywide basis. By definition, such blanket assertions of wrongdoing carry no stigma, no reputational harm, and no negative

²⁶⁸ Owen Fiss, *Against Settlement*, 93 YALE L. J. 1073 (1984). For a more recent version, see Dana A. Remus & Adam S. Zimmerman, *The Corporate Settlement Mill*, 101 VA. L. REV. 129, 132 (2015).

²⁶⁹ Rakoff, *supra* note 28; see Urska Velikonja, *Securities Settlements in the Shadows*, YALE L. J. FORUM (Sept. 7, 2016); Priyah Kaul, *Admit or Deny: A Call for Reform of the SEC’s ‘Neither-Admit-Nor-Deny’ Policy*, 48 MICH. J. L. REFORM 535 (2015); Ross MacDonald, *Setting Examples, Not Settling: Toward a New SEC Enforcement Paradigm*, 91 TEX. L. REV. 419 (2012).

²⁷⁰ See Samuel Issacharoff & Robert H. Klonoff, *The Public Value of Settlement*, 78 FORDHAM L. REV. 1177 (2009); *Parklane Hoisery Co. v. Shore*, 439 U.S. 322 (1979) (SEC must have discretion to settle in order to efficiently enforce regulations).

signal to the market.²⁷¹ This point was made clear by the Benchmark Settlements, when guilty pleas were awkwardly shoehorned into certain settlements, and investors did not bat an eye.²⁷² With regulation by settlement, “a fine is a price”—no matter how it is labelled.²⁷³ Admissions of wrongdoing will only carry the force that their proponents desire in a much more minimalist, selective enforcement regime.

A second variety of objections centers around the claim that regulatory settlements are contrary to “rule of law” principles, in various ways.²⁷⁴ One threshold vulnerability of this position is that there is no obvious consensus over what precise, concrete requirements the rule of law entails.²⁷⁵ Like “justice,” the rule of law label is more of a conclusion than a description, and can often stand for nothing more than the mix of legal-political norms that are preferred or simply familiar to the user. That practice is especially problematic in the regulatory settlement context, because settled principles of administrative law are often met with extreme skepticism, and perfectly mundane practices—agency adjudication, guidance through nonlegislative rules, enforcement of insider trading—are considered exercises in lawlessness.²⁷⁶ The general posture of these arguments can be understood as an accidental alliance, between a majority of the business law literature on one hand, and an embattled minority of public law scholars on the other, the latter of which deny the legitimacy of the post-New Deal regulatory state as a whole.²⁷⁷

Although there is a more charitable reading of the rule of law critique, it runs into even deeper problems. This Article claims that there is an identifiable collection of legal principles that works to constrain most forms of administrative policymaking, but does not apply to regulation by settlement. A plausible implication is that regulatory settlements now present a rare, genuine threat to rule of law values. The issue is that adopting such a view does not end the analysis,

²⁷¹ See Jonathan R. Macey, *THE DEATH OF CORPORATE REPUTATION: HOW INTEGRITY HAS BEEN DESTROYED ON WALL STREET* 235-36 (2013).

²⁷² See Dexheimer, *supra* note 138.

²⁷³ Uri Gneezy & Aldo Rustichini, *A Fine is a Price*, 29 J. LEGAL STUD. 1 (2000); cf. Daniel Fischel & Alan O. Sykes, *Corporate Crime*, 25 J. LEGAL. STUD. 319 (1996).

²⁷⁴ Jennifer Arlen, *Prosecuting Beyond the Rule of Law: Corporate Mandates Imposed Through Deferred Prosecution Agreement*, J. LEGAL ANALYSIS (forthcoming 2016).

²⁷⁵ See Richard H. Fallon, Jr., ‘The Rule of Law’ As A Concept in Constitutional Discourse, 97 COLUMB. L. REV. 1, 1 (1997) (“Significantly, however, the meaning of the phrase ‘the Rule of Law’ . . . has always been contested.”). Debates relating to the rule of law reflect a dilemma that applies to most cases of radical theoretical disagreement, such as those found in moral philosophy: consensus over specific cases cannot be generalized to broader conceptual categories, while agreement on abstract concepts only takes place at a level of specificity that is insufficient to apply them to particular cases. Cf. Bernard Williams, *ETHICS AND THE LIMITS OF MORAL PHILOSOPHY* 147-48 (1985).

²⁷⁶ A common thread in these critiques is the need for government to maintain a separation of powers structure—but the combination of government functions within the executive branch is a premise of the administrative process. See *Withrow v. Larkin*, 421 U.S. 35 (1975); see also Magill, *supra* note 165.

²⁷⁷ See, e.g. Philip Hamburger, *IS ADMINISTRATIVE LAW UNLAWFUL?* (2014); Richard A. Epstein, *THE CLASSICAL LIBERAL CONSTITUTION* (2014); Lawson, *supra* note 162.

because the rule of law is just one good that must be traded off against others.²⁷⁸ A wholesale rejection of regulation by settlement is only justified if there are no related benefits that offset the costs of administrative unorthodoxy.

In practice, regulation by settlement involves a number of costs and benefits. One obvious benefit is policy flexibility. Regulation must keep pace with rapidly changing economic conditions, which result not only from technological progress but also due to the process of regulatory arbitrage, in which firms find innovative ways to avoid compliance with the current regulatory environment.²⁷⁹ Both of these dynamics are at a high point in the financial sector, which is especially adaptive compared to other industries.²⁸⁰ Regulation by settlement is uniquely well-suited for these problems, as settlements can be put in place much more quickly than Congressional legislation or agency regulations made through the rulemaking process.

Another advantage of regulation by settlement is that, due to the lack of constraints from other governmental actors, it is a relatively powerful way to leverage agency expertise. With regulatory settlements, agencies can stretch statutory language liberally and are therefore not closely bound to Congressional policy judgments. The limited availability of judicial review also preserves agency policy decisions against second-guessing by the courts. The confidentiality of settlement negotiations also forecloses significant public scrutiny and popular pressure. These features appear questionable at first glance, but become assets when effective policy turns on highly technical issues rather than broad value judgments. The historical independence of the federal reserve to control monetary policy is perhaps the ultimate example of technocratic autonomy, and the justifications for that arrangement hold true across finance more generally.

Against the benefits of flexibility and expertise, regulation by settlement also presents certain costs. One potential cost arises from the fact that regulatory settlements, even when used in systematic fashion, tend to signal legal standards that have limited specificity. The vagueness of regulation by settlement means that it may leave regulated industries uncertain as to what constitutes legal compliance,

²⁷⁸ For example, the regulation of emergencies often requires neglect of standard legal formalities, but that is considered an appropriate and unavoidable cost of exigency. This is exactly what happened during the financial crisis with “regulation by deal.” See Davidoff & Zaring, *supra* note 6; cf. Adrian Vermuele, *Optimal Abuse of Power*, 109 NW. L. REV. 673 (2014). There are prominent philosophical perspectives that are arguably in tension with this view. See John Rawls, *A THEORY OF JUSTICE* 42-45, 235-43 (1971) (defending the idea of a social contract that incorporates “lexigraphical” preferences, for which the fairness of society’s basic institutional and legal structures takes absolute priority over other considerations); Ronald Dworkin, *TAKING RIGHTS SERIOUSLY* (1978) (presenting a similar argument in which rights are “trumps”). The American legal system does not tend to adopt the position of Rawls and Dworkin, and allows tradeoffs between rights against other values in most contexts, including Fifth Amendment due process rights. See, e.g., *Mathews*, *supra* note 239 (laying out a balancing test for procedural due process).

²⁷⁹ For a more general argument regarding the “social acceleration of time” phenomenon in advanced capitalist democracies, see SCHEUEREMAN, *supra* note 164.

²⁸⁰ See Merrill, *supra* note 2 (noting “quicksilver” aspect of the financial industry); Matthew C. Turk, *The Convergence of Insurance with Banking and Securities Industries, and the Limits of Regulatory Arbitrage in Finance*, 2015:4 COLUMB. BUS. L. REV. 968 (2015).

and thereby deter otherwise desirable economic activity. At the same time, this point should not be overstated. The “rules versus standards” literature does not present strong across-the-board conclusions regarding the optimal specificity of legal rules, and regulations that retain a degree of ambiguity are likely preferable in certain areas, including financial fraud.²⁸¹ In addition, the case studies indicate that agencies are sometimes able to wring a surprising amount of precision out of settlements: a hospital administrator in Tajikistan is most likely a “foreign official” for purposes of the FCPA.

A greater concern than the verbal specificity of a legal standard is whether the underlying policy it applies is misguided. regulation by settlement has two features that may bias the policies it produces in a systematic manner. One is the “multiple enforcers” issue. Particularly in finance, it is increasingly common for several agencies to enter into regulatory settlements with respect to a single firm and course of conduct. That raises the complicated problem of inter-agency coordination.²⁸² Even if it is possible for a single agency to identify a socially optimal settlement structure, multi-agency enforcement introduces the subsequent hurdle of aggregation across enforcement actions.

A second source of policy bias relevant to regulation by settlement comes from what are known as “public choice” or “political economy” problems—the presence of incentives that reward government actors for departures from impartial, public-regarding decision-making.²⁸³ Political economy problems are likely to be acute in the context of regulatory settlements, where skyrocketing corporate penalties present opportunities for “for-profit public enforcement” and a general pull towards over-deterrence.²⁸⁴ Public choice dynamics appear at multiple levels of the executive hierarchy. First, there is a revolving door for individual regulators, who can obtain career rewards by maximizing enforcement penalties—gaining a reputation for achieving large fines enhances a regulator’s exit opportunities, by signaling professional aptitude while also growing the market for compliance services.²⁸⁵ Second, at the agency level, there is the classic model of bureaucratic aggrandizement: the larger the bureaucracy the more powerful the bureaucrat. There

²⁸¹ See Julian J. Z. Polaris, *Backstop Ambiguity: A Proposal for Balancing Specificity and Ambiguity in Financial Regulation*, 33 *YALE L. & POL’Y REV.* 231 (2014); cf. Louis Kaplow, *A Model of the Optimal Complexity of Legal Rules*, 11 *J. L. ECON. & ORG.* 150 (1995) Colin S. Diver, *The Optimal Precision of Administrative Rules*, 93 *YALE L. J.* 65,66 (1983).

²⁸² See Jody Freeman & Jim Rossi, *Agency Coordination in Shared Regulatory Space*, 125 *HARV. L. REV.* 1131, 1145-51 (2012); cf. Max Minzer, *A Sentencing Commission for the Administrative State?* 103 *GEO. L. J. (ONLINE)* 87 (2015).

²⁸³ See generally Dennis C. Mueller, *PUBLIC CHOICE III* (2003); Daniel A. Farber & Philip P. Frickey, *LAW AND PUBLIC CHOICE: A CRITICAL INTRODUCTION* (1991).

²⁸⁴ See Matthew C. Turk, *A Political Economy Approach to Reforming the Foreign Corrupt Practices Act*, 33 *N’WESTERN J. INT’L L. & BUS.* 325 (2013); Margaret H. Lemos & Max Minzer, *For-Profit Public Enforcement*, 127 *HARV. L. REV.* 853 (2013).

²⁸⁵ Wentong Zheng, *The Revolving Door*, 90 *NOTRE DAME L. REV.* 1265 (2016). As one example of this dynamic: on the same day that the New York’s Department of Financial Services announced a multi-million-dollar ForEx settlement with Barclays, its commissioner announced that he was leaving the public sector to start a consulting firm. Jessica Silver-Greenberg & Ben Protess, *Benjamin Lawsky, Sheriff of Wall Street, Is Taking Off His Badge*, *N.Y. TIMES DEALBOOK*, (May 20, 2015).

is some evidence of this model at work in recent regulatory settlements, where agencies inflate annual enforcement statistics and advertise themselves as “profit centers” of the federal government as part of Congressional or executive budget requests.²⁸⁶ Lastly, there are public choice problems at the higher levels of the political process that are especially relevant for financial regulation. A common theme at the intersection of political and financial history is that when governments seek out vehicles for wealth redistribution, the banking system often presents a tempting (but ultimately costly) substitute for the tax system.²⁸⁷

The preceding discussion has focused on isolating the key concepts and factors that are necessary to consider in evaluating regulation by settlement. It is likely impossible to weigh them collectively in a way that supports a categorical conclusion about the desirability of recent settlement practices one way or the other. The most plausible interpretation is that regulatory settlements can be a quite effective regulatory tool in some contexts but perform poorly in others. An implication is that policy reforms should be incremental, searching for ways to improve the cost-benefit profile of regulatory settlements at the margin.

B. Reforming Regulation by Settlement

The rise of regulatory settlements has attracted substantial attention and inspired suggestions for a wide variety of policy responses. Although an exhaustive analysis of each proposal is beyond the scope of this Article, the overview that follows identifies the general strengths and weaknesses of existing ideas and recommends some further directions for reform.

A common theme of most commentary is the need to facilitate greater scrutiny of the settlement process. The preferred mechanism to do so varies, but some popular options can be canvassed briefly. The most straightforward proposal is for federal judges to unilaterally assert more stringent standards of judicial review for settlements, as exemplified by Judge Rakoff’s *Citigroup* decision.²⁸⁸ An alternative approach would rely on Congressional intervention, through legislation that expressly provides an enhanced judicial review mechanism.²⁸⁹ Another legislative remedy, which is already proceeding through Congress, is the “Truth in Settlements Act,” which requires greater public disclosure of the terms in regulatory settlements.²⁹⁰ Other proposals turn to the agencies themselves. One influential idea is for the DoJ to adopt guidelines that standardize the negotiating process for

²⁸⁶ See Velikonja, *supra* note 44.

²⁸⁷ See generally Charles W. Calomiris & Stephen H. Haber, *FRAGILE BY DESIGN: THE POLITICAL ORIGINS OF BANKING CRISIS & SCARE CREDIT* (2014); cf. Andy Koenig, *Look Who’s Getting that Banking Settlement Cash*, WALL. ST. J. (Aug. 28, 2016) (detailing how a significant portion of proceeds from the Securitization Settlements and Mortgage Servicing Settlements have been channeled to politically connected groups, rather than the U.S. Treasury).

²⁸⁸ See *Citigroup*, *supra* note 205.

²⁸⁹ See Brandon Garrett, *The Corporate Criminal as Scapegoat*, 101 VA. L. REV. 1789, 1842-44 (2015).

²⁹⁰ Truth in Settlements Act, S. 1109, 114th Cong. (as passed by Senate, Sept. 21, 2015).

PDAs.²⁹¹ The scholarship has also recommended that agencies make the settlement process more transparent and participatory by conducting public hearings prior to finalizing terms.²⁹²

The proposals outlined above each raise particularized difficulties, but in the context of regulation by settlement, they share one common conceptual shortcoming. That is because they are all premised on oversight mechanisms that would examine individual settlements in isolation. There is a quality control orientation to these approaches, which assumes that the relevant policy problem is to encourage best practices through procedures that deter or otherwise weed out ill-advised settlement terms (or entire agreements). That assumption may be unproblematic in a traditional criminal law context, where outlier conduct by a limited group of rogue prosecutors is a major source of policy dysfunction. But it fits poorly with the current corporate enforcement environment, in which settlements tend towards boilerplate and uniformity has, if anything, gone to extremes.

A good example is the Swiss Bank Settlements, which involved the DoJ concluding over 70 PDAs within a two-year period. The terms in those agreements do not vary widely, or at all. The urgent question raised by that episode is not whether “PDA #47” has flouted a guideline, or can survive the rigors of a public hearing, or pass the eye test of a randomly assigned federal judge. Rather, what is at stake is whether the entire, programmatic imposition of liability has a sound policy rationale when considered as a whole: what its implications are for the structure of the international banking system; whether it will have a positive or negative impact on systemic financial risks; how other financial institutions around the world will interpret its significance as regulatory precedent, and what actions they may take in response; the reaction in various international markets; and so on. The underlying point is that the conventional logic of dispute resolution does not apply to regulation by settlement—which verges on macroeconomic policy in its scale. Therefore, reforms that would supply a useful source of procedural regularity in prior eras will not address contemporary regulatory dilemmas.

A distinct reform strategy that has been put forward seeks to assess regulatory settlements at a more aggregate level. The ideas in this area build off of the “presidential administration”²⁹³ motif that originated in the rulemaking context, and look for ways to develop more sophisticated procedures for centralized oversight of administrative enforcement (and adjudication) practices within the executive branch.²⁹⁴ The Obama administration has already taken a significant first step in this direction, by issuing its “Memorandum on Regulatory Compliance” in

²⁹¹ See Arlen, *supra* note 274; cf. Garrett, *supra* note 289, at 893 (“No DoJ guidelines define what remedies prosecutors should seek when they negotiate structural reform agreements.”).

²⁹² See Velikonja, *supra* note 269, at 134-35.

²⁹³ See Kagan, *supra* note 13, Lessig & Sunstein, *supra* note 13.

²⁹⁴ See Andrias, *supra* note 245 at 1101-07; Shah, *supra* note 249, at 858-81; see generally Nicholas Bagley & Richard L. Revesz, *Centralized Oversight of the Regulatory State*, 106 COLUMB. L. REV. 1261 (2006).

2011.²⁹⁵ That document directs agencies to compile enforcement data in a transparent and accessible format so that comparisons can more easily be made across agencies. The overall goal is information-sharing as a means to facilitate inter-agency coordination. The presidential administration proposals aim to deepen that general strategy, primarily by institutionalizing the enforcement oversight function within the OMB, as part of OIRA or with a new equivalent body.²⁹⁶

Enhancing the executive branch infrastructure to allow for holistic oversight of administrative enforcement is the most promising measure that has been advocated for managing the future development of regulatory settlements. It addresses the one of the core challenges posed by regulation by settlement—the need for inter-agency coordination—and also reflects a response to the increasingly interrelated structure of regulatory settlements. In addition to the steps detailed in existing proposals, two further procedures could be adopted that would complement the broader undertaking of executive review.

First, because large regulatory settlements are so concentrated in the financial sector, information should be aggregated that specifically analyzes agreements in that policy area. Once compiled, that data could then serve as the basis for an impact report or equivalent analysis, prepared by the Office of Financial Research (OFR) for the Financial Services Oversight Committee (FSOC).²⁹⁷ The purpose of the report would be to evaluate how recent enforcement activity interacts with other aspects of the regulatory framework under Dodd-Frank, and the extent to which it raises issues relating to the broader stability and efficiency of the financial sector.

Second, the individual agencies responsible for financial regulation should modify their current practices regarding the reporting of enforcement activity. The annual enforcement summaries of agencies such as the SEC and CFTC currently read like giddy recaps of a highly successful fundraising drive.²⁹⁸ The most appropriate interpretation of regulation by settlement, however, is that enforcement essentially functions as an implicit rulemaking process and serves as boundary marker for sound industry practices. In other words, enforcement is now predominantly a regulatory device, not a backstop against outlawry. There should therefore be some annual accounting of enforcement activity by financial agencies

²⁹⁵ Presidential Memorandum on Regulatory Compliance, 76 Fed. Reg. 3825 (Jan. 18, 2011).

²⁹⁶ Andrias, *supra* note 245, at 1174-1101.

²⁹⁷ The FSOC was established by Dodd-Frank with the specific purposes of filling a previous gap in the regulatory architecture, which had no one central body responsible for monitoring the banking system from a global perspective. The OFR is also a creation of Dodd-Frank, and functions as a research arm of the FSOC. Dodd-Frank Act § 111(b) (establishing FSOC), § 152 (establishing OFR); *see also* Eugene A. Ludwig, *Assessment of Dodd-Frank Financial Regulatory Reform*, 29 YALE J. REG. 181, 184 (2012) (“Conceptually, the single greatest advancement of Dodd-Frank is the creation of the OFR.”).

²⁹⁸ *See, e.g.* CFTC Annual Enforcement Results, Fiscal Year 2015, *supra* note 44.

that treats aggregate dollar penalties collected as a policy variable to be optimized in light of related factors, rather than a metric of success.²⁹⁹

To summarize, the current regulatory enforcement environment is complex, and not amenable to grand over-arching reforms. At the same time, two high level principles should guide policy adjustments in this area. First, reform must shift from procedures that seek to manicure settlements at an individual level and take a more systemic view that focuses on broader patterns of enforcement. Second, as part of the process of developing centralized executive branch oversight of enforcement patterns, there is value-added in concentrating those efforts on agencies responsible for financial regulation, and facilitating an active role in that process by entities that Dodd-Frank has established for systemic monitoring of the financial sector.

V. Conclusion

This Article examines the evolution of enforcement settlements between federal regulators and firms. It argues that the increased scale and innovative legal form that those practices have taken amounts to a novel regime of regulation by settlement, with significant implications for scholarship on both financial regulation and administrative law. The legal framework that has been developed to govern the post-crisis financial system is not just a product of Dodd-Frank, as is conventionally assumed. Instead, rules established under that regulatory infrastructure sit alongside a substantial body of implicit legal standards that have been promulgated through the precedential signal set by regulatory settlements, which agencies have used in a systematic fashion to target certain areas of the financial sector. A new genre of administrative policymaking has emerged in the process. By removing nearly all of the legal constraints familiar to conventional forms of agency action, regulation by settlement has an unruliness reminiscent of administration during periods of emergency, and other unorthodox styles of executive policymaking. Financial regulation is an historical and institutional centerpiece of administrative law, yet existing legal scholarship largely fails to explore the intersection of those two fields. The broader contribution of this Article is to bridge that gap in the literature by analyzing the business law and public law aspects of the regulatory process in conjunction.

²⁹⁹ An equivalent to the current state of affairs among financial regulators would be reports by OSHA or the EPA that intentionally inflate and highlight the compliance costs that those agencies' regulations impose on businesses.