

# BANK GOVERNANCE AND SYSTEMIC STABILITY: THE “GOLDEN SHARE” APPROACH

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## INTRODUCTION

The global financial crisis of 2008–2009 has taught the world many invaluable lessons. One such lesson concerns the central importance of the banking sector and its regulation for the stable and efficient functioning of the global financial system—a subject matter considered too boring and old-fashioned in the precrisis era of fascination with financial innovation in capital markets and so-called disintermediation of banks. In the wake of the crisis, policy-makers’ attention, both domestically and globally, has been directed primarily at correcting mistakes of the deregulatory precrisis period and strengthening and recalibrating the regulatory and supervisory framework for banks and other systemically important financial institutions (SIFIs). The crisis shattered the unfettered faith in the traditional notions of market discipline, market rationality, industry self-regulation, and internal risk management as sufficiently reliable mechanisms of market self-correction.<sup>1</sup> Accordingly, the explicit focus of postcrisis reforms on macroprudential regulation reflects our collective realization that safeguarding systemic financial stability requires a more assertive and effective government oversight of individual banks’ and other financial institutions’ business operations.<sup>2</sup>

But where does that leave banks’ internal governance? Does firm governance have any role as a mechanism of crisis prevention, or are externally imposed regulation and supervision the only viable means of achieving this goal? Scholars of corporate governance continue to grapple with this question. Some of them advocate for corporate governance as a more effective or market-friendly alternative to what they see as excessive government intervention in private firms’ affairs.<sup>3</sup> Others seek to adjust or enhance some of the traditional corporate governance tools to aid, rather

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1. Perhaps one of the most revealing moments in this respect came in October 2008, when the former Chairman of the Board of Governors of the Federal Reserve System (the Federal Reserve), Alan Greenspan, publicly admitted that he had erred in putting too much faith in the self-correcting powers of free markets. See Edmund L. Andrews, *Greenspan Concedes Error on Regulation*, N.Y. TIMES (Oct. 23, 2008), <http://www.nytimes.com/2008/10/24/business/economy/24panel.html>; see also RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION 114–15 (2009) (arguing that rational profit-maximizing behavior of market actors produces negative externalities that cannot be controlled without government regulation). For a more recent discussion, see David Min, *Understanding the Failures of Market Discipline*, 92 WASH. U. L. REV. 1421 (2015).

2. For in-depth analyses of the postcrisis shift to macroprudential regulation, see Robert Hockett, *The Macroprudential Turn: From Institutional 'Safety and Soundness' to Systematic 'Financial Stability' in Financial Supervision*, 9 VA. L. & BUS. REV. 201 (2015), Gabriele Galati & Richhild Moessner, *Macroprudential Policy – A Literature Review* (Bank for Int'l Settlements, Working Paper No. 337, 2011), [www.bis.org/publ/work337.pdf](http://www.bis.org/publ/work337.pdf), and INT'L MONETARY FUND, MACROPRUDENTIAL POLICY: AN ORGANIZING FRAMEWORK (2011), [www.imf.org/external/np/pp/eng/2011/031411a.pdf](http://www.imf.org/external/np/pp/eng/2011/031411a.pdf).

3. See, e.g., Valentina Bruno & Stijn Claessens, *Corporate Governance and Regulation: Can There Be Too Much of a Good Thing?*, 19 J. FIN. INTERMEDIATION 461 (2010); Sean J. Griffith, *Corporate Governance in an Era of Compliance*, 57 WM. & MARY L. REV. 2075 (2016).

than supplant, regulatory efforts.<sup>4</sup> The Dodd-Frank Act, the centerpiece of the postcrisis reform legislation, mandates various measures aimed at strengthening internal risk oversight at U.S. banks and other SIFIs.<sup>5</sup> In passing the Act, Congress sought to broaden the responsibilities of the boards of directors of such institutions, with an eye toward safeguarding the long-term stability of the U.S. financial system. Regulators have voiced the need to consider special bank governance measures as a tool of postcrisis prudential regulation.<sup>6</sup> And, across the board, there are calls for improving the risk-taking culture at banks and other financial institutions.<sup>7</sup>

Unfortunately, it is not clear whether, and to what extent, any such newly enhanced corporate governance requirements would succeed in changing banks' private profit-oriented culture and preventing excessive accumulation of risk in the financial system. Part of the problem is the sheer technical difficulty of managing systemic risk in today's dynamic and complex financial markets. More fundamentally, however, the limited utility of traditional corporate governance as a mechanism of systemic risk management reflects deep-seated inadequacies in the conceptual and normative apparatus of modern U.S. corporate law.<sup>8</sup> Its prevailing notions of what a corporation is, what goals it does or should legitimately pursue, and whose interests its directors and managers do or should serve, are simply not capacious enough to be able to incorporate a meaningful emphasis on the interests of society as a whole.<sup>9</sup> The dominant conception of the corporate form as a contractually created vehicle for maximizing shareholder value is inimical to the idea of making business corporations—or their directors and officers—agents of the broader public interest. To the extent the private and public interests can be legitimately reconciled, it is usually done at the periphery, in an attempt to find “win-win” solutions that benefit both society and individual shareholders. Curbing excessive executive compensation practices at systemically important banks, for example, is one such area where regulatory objectives—and the public interest they serve—are largely in line with the tenets of the corporate law

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4. See, e.g., Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247 (2010).

5. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of the U.S. Code).

6. See, e.g., William C. Dudley, President & Chief Exec. Officer, Fed. Reserve Bank of N.Y., *Enhancing Financial Stability by Improving Culture in the Financial Services Industry* (Oct. 20, 2014), <https://www.newyorkfed.org/newsevents/speeches/2014/dud141020a.html>; Daniel K. Tarullo, Governor, Bd. of Governors of the Fed. Reserve Sys., *Corporate Governance and Prudential Regulation* (June 9, 2014), <https://www.federalreserve.gov/newsevents/speech/tarullo20140609a.htm>.

7. See, e.g., *Governance & Culture Reform: Archive*, FED. RES. BANK N.Y., <https://www.newyorkfed.org/governance-and-culture-reform/archive.html>.

8. For a detailed discussion of why this is the case, see Robert C. Hockett, *Are Bank Fiduciaries Special?*, 68 ALA. L. REV. 1071 (2017).

9. See *infra* Part I.A.

and theory.<sup>10</sup> All too often, however, the incentives of bank managers and shareholders to pursue short-term private gains are perfectly aligned but work directly against the public interest in preserving long-term financial stability.<sup>11</sup> The recent financial crisis exposed how these socially destructive dynamics operate in practice.<sup>12</sup> It also made abundantly clear that the modern system of corporate governance, with its traditional focus on solving specific principal-agent problems within a firm, is not a sufficiently reliable or consistent mechanism for managing this insidious and apparently pervasive conflict in a publicly beneficial way.

This Article accepts the existence of that built-in potential conflict as the critical starting point for answering the central question of postcrisis bank governance: How do we ensure that the board of directors of a privately owned banking institution consistently and effectively acts in a manner that serves the overarching public interest in safeguarding long-term systemic financial stability? The Article offers an unorthodox solution to this problem: in lieu of “improving” or “tweaking” existing standards and procedures that determine board composition or guide specific board actions, it advocates a fundamental structural reconfiguration of bank governance by giving the federal government a seat on the board of each systemically important banking organization.

Specifically, the Article proposes a special “golden share” regime that would grant direct but conditional management rights to a designated government representative on the board of each affected institution.<sup>13</sup> The goal of the proposed regime would be to create a powerful organizational node of public-interest-driven management, which would operate as a dynamic and flexible internal “emergency brake” on individual banks’ activities presenting significant systemic stability concerns. To paraphrase a staple metaphor, this mechanism would effectively enable the federal government to accept the role of the “manager of last resort” of a systemically significant financial firm—but only temporarily and well

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10. See, e.g., Bebchuk & Spamann, *supra* note 4.

11. See Hockett, *supra* note 8.

12. For detailed analyses of market-wide and firm-specific dynamics that resulted in unsustainable levels of risk and leverage in the financial system, see FIN. CRISIS INQUIRY COMM’N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES (2011), <https://www.gpo.gov/fdsys/pkg/GPO-FCIC.pdf>; S. PERMANENT SUBCOMM. ON INVESTIGATIONS, 112TH CONG., WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE 394 (2011), [http://hsgac.senate.gov/public/\\_files/Financial\\_Crisis/FinancialCrisisReport.pdf](http://hsgac.senate.gov/public/_files/Financial_Crisis/FinancialCrisisReport.pdf); FIN. SERVS. AUTH., THE TURNER REVIEW: A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS (2009), [http://www.ecgi.org/tcgd/2009/FSA\\_Turner\\_Report\\_on\\_Financial\\_Crisis\\_2009.pdf](http://www.ecgi.org/tcgd/2009/FSA_Turner_Report_on_Financial_Crisis_2009.pdf).

13. The proposal advanced in this Article builds upon and elaborates the concept originally formulated in Robert C. Hockett & Saule T. Omarova, *Public Actors in Private Markets: Toward a Developmental Finance State*, 93 WASH. U. L. REV. 103, 167–74 (2015) [hereinafter *Public Actors*].

before that firm's actions threaten to bring down the financial system.<sup>14</sup> Importantly, the proposed golden share regime is neither a nationalization measure nor an institutionalized bank bailout. Its overarching purpose is not to put the federal government in charge of private firms but, on the contrary, to steer the firms toward self-correcting and preventative actions necessary to avoid that undesirable result. In effect, the golden share regime would operationalize a novel approach to bank—and, more broadly, SIFI—corporate governance as an inherently hybrid public–private process.<sup>15</sup>

A proposal of this kind is bound to raise potentially significant issues of legal doctrine and practical implementation. The present Article does not purport to offer a full set of solutions to all of these problems; it merely outlines in principle the key elements of the proposed regime's design and operation. The proposal advocated here is essentially a thought experiment: an attempt to push the boundaries of the familiar debate and to stimulate a productive discussion of how public our privately owned banks and other systemically significant financial institutions really are—and how public-minded their internal governance should be.

The Article proceeds as follows. Part I lays out a broad normative justification for the golden share proposal. Parts II and III outline basic substantive and operational features of the proposed regime. Part IV addresses some of the key issues in connection with the institutional design and administration of the proposed scheme.

## I. RETHINKING THE PUBLIC'S ROLE IN BANK GOVERNANCE: TOWARD A NEW PARADIGM

### A. *Bank Governance and Financial Stability: An Unresolved Tension*

The term “corporate governance” generally refers to the system of intrafirm structures and procedures through which shareholders and other stakeholders in the firm exercise control over its management.<sup>16</sup> In the

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14. The federal bank regulators, such as the Federal Deposit Insurance Corporation (FDIC), already act as managers of last resort with respect to banks that are either insolvent or meet certain statutory standards for so-called prompt corrective action. See 12 U.S.C. § 1831o (2012). In that sense, the proposal advanced here should not be seen as a truly radical departure from the existing practice. Nevertheless, as discussed below, granting more flexible and direct internal-management rights to a special public instrumentality that does not perform regulatory or supervisory functions and acts strictly as a market actor would create a qualitatively new arena for systemic risk prevention and, in that sense, constitute a radical departure from the current regime. See *infra* notes 116–121 and accompanying text.

15. See *infra* Part IV.C.

16. See Jens Hagendorff, *Corporate Governance in Banking*, in THE OXFORD HANDBOOK OF BANKING 139, 139 (Allen Berger et al. eds., 2d ed. 2015). According to one influential definition, “[c]orporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which

United States, where corporate law is a matter of state law, the model of corporate governance focuses primarily on potential conflicts of interest between equity holders, as residual claimants on the firm's assets, and corporate managers and directors to whom they delegate the day-to-day control over the firm's business affairs.<sup>17</sup> In the academic literature, this fundamental tension is generally referred to as the “agency problem,” or a problem of motivating the agents—who possess superior information and decision-making authority—to act in the best interests of the principals.<sup>18</sup> The agency problem remains the dominant analytic and normative focus of mainstream U.S. corporate law scholarship and continues to dominate academic and policy discussions on corporate governance. Critically, this mainstream paradigm generally views shareholders as the only legitimate category of principals in the corporate context and, accordingly, approaches problems of corporate governance from a fundamentally shareholder-centric perspective.<sup>19</sup> Among other things, it provides the basis for the currently dominant claim that the sole legitimate corporate purpose is, and should be, maximization of shareholder value.<sup>20</sup>

One of the key legal mechanisms for addressing the agency problem and reducing shareholders' agency costs is the imposition of a special set of fiduciary duties on corporate managers and, importantly, board members. Under U.S. corporate law, the board of directors is charged with the crucial task of managing and supervising the business and affairs of the corporation.<sup>21</sup> The dominant paradigm accordingly views fiduciary duties as indispensable gap fillers in the fundamentally contractual relationship

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the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.” ORGANISATION FOR ECON. CO-OPERATION & DEV., G20/OECD PRINCIPLES OF CORPORATE GOVERNANCE 9 (2015), <http://www.oecd-ilibrary.org/docserver/download/2615021e.pdf?expires=1488685295&id=id&accname=guest&checksum=58B3733B64C7598CF12D0C0A72EB8FB8>.

17. See, e.g., D. GORDON SMITH & CYNTHIA A. WILLIAMS, BUSINESS ORGANIZATIONS 174 (3d ed. 2012) (“Many of the issues that arise under corporate law relate to conflicts between the board of directors and the shareholders.”).

18. The economic and legal literature on the essence of the agency problem and the significance of minimizing “agency costs” in a corporate setting is simply too voluminous to cite here. For a succinct overview of the agency problem as a subject of corporate law, see John Armour, Henry Hansmann & Reinier Kraakman, *Agency Problems and Legal Strategies*, in THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 35 (Reinier Kraakman et al. eds., 2d ed. 2009).

19. Once again, citing in a meaningful way an extensive body of literature proffering this dominant (at least, in the Anglo-American context) shareholder-centric perspective on corporate governance would be a futile task. For a compelling critique of the shareholder-centric view of a modern corporation, see LYNN STOUT, THE SHAREHOLDER VALUE MYTH (2012).

20. For recent critical analyses of the “shareholder value maximization” paradigm, see *id.*; Robert C. Hockett & Saule T. Omarova, “*Special, Vestigial, or Visionary? What Bank Regulation Tells Us About the Corporation—and Vice Versa*,” 39 SEATTLE U. L. REV. 453 (2016).

21. See SMITH & WILLIAMS, *supra* note 17, at 174 (“Officers . . . are in charge of the day-to-day operations of the corporation. . . . and they make many of the decisions that define a corporation's activities. . . . [The board of d]irectors [is] elected by shareholders to supervise the officers.”).

between shareholders and their agents, which “essentially call on directors to work hard and to promote the interests of shareholders above their own.”<sup>22</sup>

As fiduciaries, directors are subject to the duty of care and the duty of loyalty and may be personally liable to the corporation’s shareholders for the damages caused by the breach of those duties.<sup>23</sup> In general, directors are required to exercise reasonable care, prudence, and diligence in managing and supervising the corporation’s affairs. However, the judicially developed “business judgment rule” protects them from liability for bad judgment calls, as long as directors followed reasonable due diligence procedures.<sup>24</sup> In most states, plaintiffs can sustain their burden of proof only by showing that directors acted with gross negligence, a standard that is much stricter than ordinary negligence.<sup>25</sup>

These fundamental principles of corporate law and governance generally apply to banking institutions that are typically organized as corporations. At the same time, however, modern banks represent a very special type of business corporation, which complicates straightforward application of such principles in the banking context.

Thus, it has long been recognized, albeit not without controversy, that deposit-taking banks are “special” even among financial institutions.<sup>26</sup> Banks are said to be special in that they perform certain important public functions: they provide transactional accounts, operate payment systems, and serve as channels for transmission of monetary policy.<sup>27</sup> While each of these functions can be, and often is, performed by various nonbank institutions, banks have historically combined them in a way and on a scale not evident outside the banking system, which led many to view banks as

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22. Jonathan R. Macey & Maureen O’Hara, *The Corporate Governance of Banks*, 9 FRBNY ECON. POL’Y REV. 91, 93 (2003).

23. *Id.* Some scholars treat the duty of good faith as a separate and distinct form of fiduciary duty. For the purposes of this Article, however, these and other doctrinal and theoretical nuances are largely irrelevant.

24. See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (stating a presumption that “in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company”).

25. See Heidi Mandanis Schooner, *Fiduciary Duties’ Demanding Cousin: Bank Director Liability for Unsafe or Unsound Banking Practices*, 63 GEO. WASH. L. REV. 175, 186–87 (1995); Ronald W. Stevens & Bruce H. Nielson, *The Standard of Care for Directors and Officers of Federally Chartered Depository Institutions: It’s Gross Negligence Regardless of Whether Section 1821(k) Preempts Federal Common Law*, 13 ANN. REV. BANKING L. 169, 191–93 (1994).

26. For a classic articulation of this argument, see E. Gerald Corrigan, *Are Banks Special?*, in FED. RESERVE BANK OF MINNEAPOLIS, ANNUAL REPORT 1982, at 5 (1983), [https://fraser.stlouisfed.org/files/docs/historical/frbminn/1982\\_frb\\_minneapolis.pdf](https://fraser.stlouisfed.org/files/docs/historical/frbminn/1982_frb_minneapolis.pdf) [hereinafter *Are Banks Special?*]; E. Gerald Corrigan, *Are Banks Special?: A Revisitation*, REGION (Mar. 1, 2000), <http://www.minneapolisfed.org/publications/the-region/are-banks-special>.

27. See *Are Banks Special?*, *supra* note 26. For a recent restatement of the argument, see Alan M. White, *Banks as Utilities*, 90 TUL. L. REV. 1241 (2016).

quasi-public utilities.<sup>28</sup> Furthermore, banks' traditional business model, based on high leverage and large-scale maturity and liquidity transformation, renders them inherently vulnerable to creditor runs.<sup>29</sup> Banks issue very little equity, their core assets are highly opaque, and their liabilities are extremely short-term—a fragility-producing combination. In order to protect banks from failure and to ensure their ability to continue providing publicly important services, modern governments typically subsidize banks by providing them with credit and liquidity support. Thus, in the United States, the two central pillars of such support are the federal deposit insurance system, administered by the Federal Deposit Insurance Corporation (FDIC), and access to the Federal Reserve's liquidity backup facilities.<sup>30</sup>

These “special” features of banks also shaped their internal corporate governance. For example, American courts have a long history of holding bank directors to a heightened standard of duty of care, by virtue of banks' quasi-public functions.<sup>31</sup> While many of these cases preceded the advent of federal deposit insurance and even the widespread adoption of the general incorporation statutes, the importance of holding bank directors to a higher standard of care continues to be recognized to this day.<sup>32</sup> In some states, directors of state-chartered banks are subject to personal liability for breaches of the duty of care if they are found to have acted with negligence, as opposed to gross negligence.<sup>33</sup> Even self-professed supporters of the currently dominant view of the corporation as a purely private “nexus of contracts,” whose primary purpose is maximization of shareholder value, have advocated for expanding the scope of fiduciary duties of bank directors to include a duty to ensure their bank's safety and soundness.<sup>34</sup>

Characteristically, the primary object of the heightened director duties and responsibilities in all of these instances is the “safety and soundness”

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28. See *Are Banks Special?*, *supra* note 26. While this canonical articulation of banks' “specialness” identifies some of the key factors that explain the heightened public significance of banks' core business activities, it nevertheless fails to capture the more fundamental relational dynamics that render privately owned banks public agents in a more direct sense, as specially licensed *de facto* “franchisees” of the sovereign. See *infra* notes 53–56 and accompanying text.

29. See Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. POL. ECON. 401 (1983) (analyzing the general dynamics of bank runs).

30. See generally MICHAEL BARR ET AL., FINANCIAL REGULATION: LAW AND POLICY (2016).

31. See Patricia A. McCoy, *A Political Economy of the Business Judgment Rule in Banking: Implications for Corporate Law*, 47 CASE W. RES. L. REV. 1 (1996).

32. See Hagendorff, *supra* note 16; PATRICIA A. MCCOY, BANKING LAW MANUAL § 14.01, 14.04 (2013); Macey & O'Hara, *supra* note 22.

33. See BARR ET AL., *supra* note 30, at 813–14 (discussing the standard for bank director liability under the New York banking statute); MCCOY, *supra* note 32, § 14.04.

34. See, e.g., Macey & O'Hara, *supra* note 22, at 92 (“In particular, we call on bank directors to take solvency risk explicitly and systematically into account when making decisions, or else face personal liability for failure to do so.”).



of the relevant banks.<sup>35</sup> The principal doctrinal adjustment, either as sanctioned by courts or as proposed by academics, is to broaden the range of the beneficiaries of bank directors' fiduciary duties to include not only the banks' shareholders but the banks themselves—and, in certain limited circumstances, the banks' depositors.<sup>36</sup> By creating multiple new beneficiaries of directors' fiduciary duties, however, this approach potentially introduces a significant internal source of tension and conflict in the operation of the fiduciary relation within a bank.<sup>37</sup> Even more importantly, this somewhat expanded version of fiduciary duties and responsibilities of bank directors remains fundamentally tied to the familiar notion of corporate governance as a mechanism of internal organizational concern, a matter of “micro” rather than “macro” ordering. Any truly systemic positive externalities of holding individual bank directors to higher fiduciary standards are largely presumed to follow the first-order effects on the individual banks' safety and soundness, frequently used as a proxy for profitability.

The financial crisis of 2008–2009 exposed the dangers of precisely this kind of over-reliance on microprudential tools for managing critical system-wide risks. It laid bare the systemically harmful dynamics of recursive collective action problems, whereby individually rational actions by market participants led to a collectively disastrous result.<sup>38</sup> To put it simply, private market actors—firms or individuals, big or small—generally operate under strict profit-maximization constraints, which renders them excessively susceptible to immediate pressures to avoid short-term losses and to produce short-term competitive returns, even where pursuing such strategies impairs their capacity to sustain long-term profitability. Rationally responding to these pressures, individual firms and investors tend to buy inflated assets during the euphoric bubble buildup and sell them during the post-bubble downward price spiral, in both cases exacerbating the destabilizing market-wide trend.<sup>39</sup> From this perspective, declaring bank directors fiduciaries of the bank, as opposed to the bank's

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35. See, e.g., *id.*

36. See, e.g., *id.* at 98–102.

37. For an insightful analysis of the traditional concept of fiduciary duty as a status-derived obligation of the agent to act as the principal's alter ego, thus eliminating the functional difference between the two, see Hockett, *supra* note 8. As a conceptual matter, then, an agent cannot simultaneously owe the same fiduciary obligation to several principals (or beneficiaries) whose interests are not strictly identical. Introducing variations in the scope or intensity of fiduciary duty, depending on the beneficiary's relative position or other circumstances, runs the risk of altering the nature of the relation altogether.

38. Robert C. Hockett, *Recursive Collective Actions Problems: The Structure of Procyclicality in Financial and Monetary Markets, Macroeconomies and Formally Similar Contexts*, J. FIN. PERSP., July 2015, at 1.

39. See *id.*; see also *Public Actors*, *supra* note 13, at 122–37 (discussing the key differences in the relative incentives, capacities, and roles of private and public market actors).

shareholders, makes little practical difference. Even if directors faithfully discharge their duty to act in the best interests of the relevant bank, a private profit-maximizing entity, their actions can nevertheless exacerbate socially destructive boom-and-bust cycles in the financial markets.<sup>40</sup>

In the postcrisis era, systemic financial stability came to be recognized as the overarching policy goal that is explicitly separate from the goal of preserving individual entities' safety and soundness. The Dodd-Frank Act sought to strengthen the resilience of the U.S. financial system, among other things, by mandating compliance with a range of new, or newly enhanced, entity-wide risk-oversight responsibilities of the boards of directors of banks, bank holding companies (BHCs), and other SIFIs.<sup>41</sup> However, the Act does not attempt to revisit the old underlying concept of bank directors' fiduciary duties as a firm-level internal ordering device.<sup>42</sup> With respect to financial firms that are not chartered as banks—including BHCs organized as regular state-chartered corporations—a fundamental reorientation of directors' fiduciary duties toward the broader public interest in systemic stability presents an even bigger conceptual and practical challenge. Accomplishing that task would require potentially far more radical adjustments to the dominant corporate law and governance paradigm than merely tightening certain regulatory compliance requirements.

In recent years, a few legal scholars explored potential avenues for making such adjustments. For instance, under one proposal, individual firms would be required to appoint a critical mass of so-called public directors who would act as representatives of the public interest on such firms' boards.<sup>43</sup> These public directors would be either publicly elected or administratively appointed, and their principal function would be to introduce an explicitly other-regarding perspective into corporate boards' deliberations, thus making banks and other SIFIs more likely to behave in a

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40. For an insightful recent discussion of the dynamics and history of financial asset booms and busts, see ERIK F. GERDING, *LAW, BUBBLES, AND FINANCIAL REGULATION* 33–135 (2014).

41. For an overview of such board-duty-enhancing measures under the Dodd-Frank regime and implementing regulations, see MCCOY, *supra* note 32, § 14.04; Edward D. Herlihy et al., *Financial Institutions Developments: Key Trends in Financial Institutions M&A and Governance*, 52 *BANK & CORP. GOVERNANCE L. REP.* 23 (2014).

42. One of the most controversial aspects of the postcrisis reforms in bank and SIFI governance concerned the regulators' efforts to make such institutions' boards more directly responsible for the effective functioning of their firms' risk management systems, which the industry perceived as a dangerous and unworkable attempt to blur the line between directors' traditional oversight role and the managers' executive role. See, e.g., DEBEVOISE & PLIMPTON, *CLIENT UPDATE: BASEL COMMITTEE 2015 CORPORATE GOVERNANCE PRINCIPLES* (Aug. 11, 2015), [http://www.debevoise.com/~media/files/insights/publications/2015/08/20150811basel\\_committee\\_2015\\_corporate\\_governance\\_principles.pdf](http://www.debevoise.com/~media/files/insights/publications/2015/08/20150811basel_committee_2015_corporate_governance_principles.pdf).

43. See Hilary J. Allen, *The Pathologies of Banking Business as Usual*, 17 *U. PA. J. BUS. L.* 861 (2015); James Fanto, *Whistleblowing and the Public Director: Countering Corporate Inner Circles*, 83 *OR. L. REV.* 435, 490–540 (2004).

systemic-stability-enhancing manner.<sup>44</sup> Yet, it is not entirely clear whether, or why, these “public” directors would be more effective than today’s “independent” directors in counteracting “groupthink” or significantly altering the systemically harmful shareholder-value-driven board behavior.<sup>45</sup> As long as nonpublic directors’ fiduciary duties continue to be interpreted as running to the firm’s shareholders, the presence of public directors is unlikely to resolve the underlying tension between micro-rationality and macro-stability.

Another intriguing proposal targets the substantive scope of directors’ fiduciary duties, rather than the composition of SIFIs’ boards.<sup>46</sup> Under this approach, SIFI directors would owe a broader fiduciary duty of care directly to the firm, rather than its shareholders, and be liable for failure to control the firm’s systemically risky behavior that results in significant losses to that firm.<sup>47</sup> The proposal “revives the case for director-negligence liability as a method of constraining bank risk-taking, not limited to cases of bank failure but rather addressed to cases in which a large financial institution suffers losses of a magnitude and kind that could threaten the institution’s stability.”<sup>48</sup> In effect, it seeks to align directors’ interests with the interests of SIFIs’ diversified shareholders, likely to suffer greater losses from systemic distress than from any individual firm’s failure.

What makes this proposal particularly noteworthy is that, in an attempt to push conceptual boundaries, it underscores the inherent inability of the traditional corporate law and governance doctrine to accommodate the postcrisis systemic risk perspective. However sophisticated, this proposal is premised on a fundamentally questionable assumption that systemic harms can, and should, be effectively policed by individual firms’ shareholders—and on an ex post basis.<sup>49</sup> Moreover, by conditioning directors’ liability on

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44. Allen, *supra* note 43, at 901–02. It is worth noting that Professor Fanto’s original proposal was not designed specifically to apply to financial institutions. See Fanto, *supra* note 43.

45. For a discussion of the role and efficacy of independent directors on the boards of publicly listed companies, see Roberta S. Karmel, *Is the Independent Director Model Broken?*, 37 SEATTLE U. L. REV. 775 (2014).

46. See John Armour & Jeffrey N. Gordon, *Systemic Harms and Shareholder Value*, 6 J. LEGAL ANALYSIS 35 (2014).

47. Armour and Gordon offer a compelling argument as to why traditional private law mechanisms, such as tort liability, simply do not do the job of forcing SIFIs to externalize systemic harms caused by their activities. *Id.* at 37.

48. *Id.* at 64.

49. While targeting the ex post director liability regime, Armour and Gordon’s proposal is designed to force the board of directors to take a more active role in monitoring and preventing potentially systemically harmful business strategies of the firm’s management. Perhaps the fear of personal liability and shareholder suits in the event such strategies cause the firm to sustain large losses would, in fact, be a more “high-powered” director-oversight incentive than the threat of regulatory sanctions. But, even if true, this proposition does not address the key issue of whether individual directors serving on individual firms’ boards are, in fact, capable of determining—on an ex ante basis—precisely which business decisions are potentially systemically harmful and, therefore, should be vetoed

significant losses to an individual SIFI, it erroneously conflates systemic stability with “firm stability.” While the emphasis on private enforcement of directors’ fiduciary duties through shareholder litigation clearly signals the fundamental continuity of this proposal with traditional Anglo-American corporate law, it also undermines its credibility as a potential solution to the problem of systemic risk prevention.

To conclude, it appears that expanding bank directors’ fiduciary duties beyond their traditionally limited scope does not help to overcome the inherently nonsystemic, entity-centric character of this and other tools of corporate governance. At its core, fiduciary duty functions as a mechanism for structuring and managing the relationship between directors (agents) and those parties (principals or beneficiaries, shareholders or entire firms) on whose behalf or for whose benefit they run the firm’s business.<sup>50</sup> Fiduciary duty is not designed to govern directly the firm’s relationship with, and behavior toward, the rest of the outside world: it generally affects such external, outward-looking interactions only by implication, as a consequence rather than an intended goal. Acknowledging this inherent limitation of the fiduciary duty construct underscores the need to search for alternative mechanisms of incorporating the goal of systemic stability into the very fabric of banks’ internal governance processes.<sup>51</sup>

### B. *Bank Governance as a Matter of Public Interest*

As discussed above, banks have long been recognized as a “special” group of private firms that are publicly subsidized, by virtue of their supposed indispensability in ensuring smooth operation of the financial system.<sup>52</sup> More importantly, however, banks are also very “special” entities

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in spite of their short-term profitability. Such determination, by its very definition, requires the relevant decision makers to have a truly system-wide view and exercise their judgment on the basis of system-wide considerations—which gives public instrumentalities a critical built-in advantage over private actors. See *Public Actors*, *supra* note 13.

50. See Hockett, *supra* note 8.

51. It is important to emphasize here that the preceding discussion focuses not on any specific organizational or behavioral dynamics that tend to undermine corporate boards’ efficacy, but on the deep structural limitations of fiduciary duty as a potential tool of enhancing systemic financial stability. Undoubtedly, overcoming groupthink and other well-known cognitive and organizational failures of real-life corporate boards is an important element of improving the overall quality of corporate governance. However, this Article’s key point so far is that, even in the absence of such distortions, an individual firm’s directors are not properly positioned to act consistently and predominantly on behalf of the public as a whole. It would be misguided to pin our collective hopes for a more stable financial system on the prospect of maintaining such a perfect alignment of public and private interests in financial markets. Making bank directors better educated, less prone to groupthink, and more willing to question bank managers may make them better, more effective fiduciaries in a traditional sense, but it would not somehow redirect their primary duty toward the general public. For a discussion of what it might take to turn bank directors into official “public fiduciaries,” see Hockett, *supra* note 8.

52. See *supra* note 26 and accompanying text.

in a deeper, constitutive sense: though organized as privately owned corporations, banks are the quintessential public–private partnerships.<sup>53</sup> The government authorizes banks to perform vital public (i.e., sovereign) functions—creation of money and allocation of credit—for private gain. Thus, banking is not simply a private economic enterprise but a delegated public policy responsibility, and banks are not simply private companies but franchisees of the public, entrusted to aid in the continuous generation and distribution of the sovereign public’s full faith and credit.<sup>54</sup>

A full elaboration of this view of banking—and finance, more generally—as a public–private franchise is beyond the scope of this Article.<sup>55</sup> For present purposes, the key normative implication of reframing banks’ systemic function as that of a franchisee managing the flow of a vital public resource is the recognition that the sovereign public, as the franchisor, has an inherent right to control the terms on which that public resource flows throughout the economy—and to do so not only as an exogenous source of “command-and-control” regulation but as an endogenous market actor.<sup>56</sup> Accordingly, this view recasts internal corporate governance of banks and other financial firms as a matter of direct concern to the government, in its capacity as the collective agent representing the sovereign public. It creates the crucial intellectual space for designing a novel regime of direct government participation in banks’—and, broader, SIFIs’—internal management, specifically for the purpose of avoiding socially harmful shocks to the financial system. It explicitly imposes the burden of safeguarding the long-term public interest in systemic stability on the party best equipped and motivated to bear it—and to do so preemptively, from within the individual firm.

What specific form should this role take?

The sovereign franchisor, acting primarily through the Federal Reserve and the Treasury Department, injects its full faith and credit into the financial system to support and underwrite the massive flows of public and private capital in a variety of forms and through a variety of channels. It acts as the uniquely indispensable creditor, insurer, guarantor, and counterparty in a myriad of transactions that together constitute the modern financial market.<sup>57</sup> While these actions of the government as a market actor

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53. For a full elaboration of this concept, see Robert C. Hockett & Saule T. Omarova, *The Finance Franchise*, 102 CORNELL L. REV. (forthcoming 2017), <http://ssrn.com/abstract=2820176> [hereinafter *The Finance Franchise*]; see also MORGAN RICKS, *THE MONEY PROBLEM: RETHINKING FINANCIAL REGULATION* (2016), [http://search.ebscohost.com.libdata.lib.ua.edu/login.aspx?direct=true&db=nlebk&AN=1180882&site=ehost-live&ebv=EB&ppid=pp\\_Cover](http://search.ebscohost.com.libdata.lib.ua.edu/login.aspx?direct=true&db=nlebk&AN=1180882&site=ehost-live&ebv=EB&ppid=pp_Cover).

54. See *The Finance Franchise*, *supra* note 53.

55. For a fully articulated argument, see *id.*

56. See *id.*; see also *Public Actors*, *supra* note 13, at 164.

57. See *The Finance Franchise*, *supra* note 53.

often remain hidden in plain view, they are readily visible and widely acknowledged with respect to deposit-taking banks. An explicit federal guarantee of banks' privately issued deposit liabilities, in particular, makes it easy to see that, in the final analysis, the government—as a representative of the American public—stands behind private financial firms' balance sheets. In fact, an individual banking institution's entire balance sheet can be viewed as “a thick bundle of contingent claims on the government.”<sup>58</sup> Thus, at least in the context of an insured bank, it is an incontrovertible fact that the ultimate bearer of full residual risk of the bank's failure is the federal government, rather than private shareholders shielded by limited liability.<sup>59</sup>

This creates a puzzling inconsistency in our commonly accepted view of the business world. Corporate law generally identifies stockholders' equity with residual risk-bearing and accepts the intuitively just principle of reserving voting and management rights in a particular enterprise to shareholders most exposed to the risk of its failure. The intuition behind this principle is that shareholders should be able to take preventative measures lowering their risk of loss. However, the government—as the bearer of the most residual risk of bank failure, including its systemic consequences—does not have any such rights in privately owned banks. Neither the difficulty of quantifying the magnitude of potential public loss on a bank's balance sheet nor the general availability of regulatory protections justifies this presumptive denial of the government's entitlement to lower its risk through direct participation in the bank's management, in accordance with the basic tenets of corporate law and governance.<sup>60</sup> On the contrary, a conceptually coherent way to prevent socialization of losses and privatization of gains in the banking sector

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58. See Anna Gelpern, *Common Capital: A Thought Experiment in Cross-Border Resolution*, 49 TEX. INT'L L.J. 355, 356 (2014). According to Gelpern,

Like the public-policy functions, government commitments permeate the bank balance sheet. Central-bank liquidity support, deposit insurance, regulatory valuation of assets and liabilities, and resolution procedures all represent government commitments that shape the way in which a bank does business.

Other kinds of firms—hospitals, farming cooperatives, nuclear power plants, and insurance companies—might deliver public goods, receive public support, be subject to intrusive regulation, or all of the above. Banks are extreme in two ways. First, a bank's balance sheet is its policy work, most plainly visible in the combination of demand deposits (money issuance) and long-term loans (credit allocation). A hospital's financial structure is at best indirectly relevant to its impact on public health. Second, the number of policy functions and government commitments on a private bank's balance sheet is high compared to just about any other enterprise. Governments direct, value, or underwrite virtually every line of the bank balance sheet.

*Id.* (emphasis omitted).

59. The same dynamics of support operate outside the realm of the formal banking system, where the public subsidy takes on a more implicit form. See *The Finance Franchise*, *supra* note 53.

60. See *infra* notes 71–72 and accompanying text.

would be to restore the natural connection between risk and control.<sup>61</sup> Since it is unrealistic to expect private financial firms to internalize systemic risks they pose,<sup>62</sup> the only logical solution is to formalize the public's residual-risk-bearing role by granting it direct control rights in such firms.

Recognizing the public's de facto equity-like risk-bearing stake on banks' balance sheets opens up new possibilities for preventing banks from engaging in systemically risky behavior. Instead of trying to stretch the limits of the existing corporate governance rules to solve systemic problems they are not designed to solve, we can focus on creating more effective mechanisms that would put on private firms' boards a public instrumentality directly charged with protecting the public's interests. This Article explores the possibility of establishing a special golden share regime as one such alternative governance mechanism.

## II. THE GOLDEN SHARE MECHANISM: SETTING THE STAGE

This Part begins outlining a general scheme for using the golden share device as a tool for safeguarding long-term stability of the U.S. financial system. Given its far-reaching effects on the rights and responsibilities of principal stakeholders in financial firms, this new golden share mechanism will have to be created by an act of the U.S. Congress. This Part outlines the key substantive provisions of federal legislation, or the enabling statute, that would accomplish that goal. The focus is on the nature, purposes, jurisdictional scope, and basic "peacetime" operation of the proposed regime.<sup>63</sup>

### A. *The Concept of a Golden Share: Background*

In the context of government action, the term golden share denotes a wide range of legal arrangements giving the government special, exclusive, and nontransferable corporate-governance rights in privately owned enterprises. It is an instrument "that gives the state a continuing power over certain fundamental corporate decisions."<sup>64</sup> Golden shares were widely used in the 1980s during the global wave of privatizations of state-owned

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61. See *Public Actors*, *supra* note 13 at 164. See *infra* notes 71–72 and accompanying text.

62. See Armour & Gordon, *supra* note 46, at 44–64.

63. Parts II and III of this Article build and expand upon *Public Actors*, *supra* note 13, at 167–74.

64. Larry Catá Backer, *The Private Law of Public Law: Public Authorities as Shareholders, Golden Shares, Sovereign Wealth Funds, and the Public Law Element in Private Choice of Law*, 82 TUL. L. REV. 1801, 1806 n.12 (2008).

companies.<sup>65</sup> Governments used this mechanism to (1) ensure continuing national, as opposed to foreign, control over privatized companies deemed to be strategically important, especially in terms of the nation's military and economic security,<sup>66</sup> or (2) minimize post-privatization disruptions of basic social services.<sup>67</sup> The key perceived benefit of the golden share mechanism was its flexibility and malleability, which allowed for company-specific adjustments.<sup>68</sup> As a holder of the golden share, the government could have disproportionate voting power with respect to the election of the company's directors and various strategic decisions affecting the operation of the company, including decisions to merge, dispose of material assets, or enter or discontinue a particular line of business.<sup>69</sup> In effect, the golden share enabled governments "to monitor the ordinary *commercial* activity of a corporation."<sup>70</sup>

This ability to affect directly a private firm's substantive business decisions—without holding a controlling economic equity stake—is a particularly promising feature of the golden share as a potential new mechanism for preventing systemic financial shocks. The latest financial crisis underscored the danger of overreliance on private financial institutions' internal risk management and individually rational decision-making to ensure systemic stability. Formal regulatory oversight of financial institutions' activities, at least in its current form, also has significant limitations, especially given the pervasiveness of regulatory arbitrage and the increasing complexity and opacity of financial products and transactions.<sup>71</sup> As market "outsiders," financial regulators perennially

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65. When Margaret Thatcher's conservative government privatized large and economically significant British enterprises—including Britoil, Aerospace, British Telecom, and Jaguar—it retained a golden share in each of these companies, which allowed the government to out-vote other shareholders. Andrei A. Baev, *Is There a Niche for the State in Corporate Governance? Securitization of State-Owned Enterprises and New Forms of State Ownership*, 18 HOUS. J. INT'L L. 1, 20–22 (1995). Governments of France, Turkey, Israel, and post-communist countries in Eastern and Central Europe followed the British example by reserving a variety of special corporate-governance and super-voting rights in privatized firms. *See id.*; Alice Pezard, *The Golden Share of Privatized Companies*, 21 BROOK. J. INT'L L. 85 (1995).

66. *See* Pezard, *supra* note 65, at 86–87. Many European governments used their golden shares to block foreign acquisitions of corporate control in strategically important domestic firms. In a series of cases decided between 2000 and 2007, the European Court of Justice invalidated the use of the golden share for such protectionist purposes as restricting the free movement of capital in violation of the EU law. *See* Backer, *supra* note 64; Christine O'Grady Putek, *Limited But Not Lost: A Comment on the ECJ's Golden Share Decisions*, 72 FORDHAM L. REV. 2219 (2004).

67. *See* Baev, *supra* note 65, at 36–38.

68. *See* Stefan Grundmann & Florian Möslin, *Golden Shares—State Control in Privatised Companies: Comparative Law, European Law and Policy Aspects*, 2001 EUR. BANKING & FIN. L. J. 623.

69. *See* Baev, *supra* note 65, at 23–27.

70. *Id.* at 27.

71. For a discussion of the role complexity plays in reducing the efficacy of the current regulatory regime, see, for example, Saule T. Omarova, *License To Deal: Mandatory Approval of*



lag behind private market participants in their ability to access and process vital market information, and their ability to act is inherently limited by various jurisdictional constraints.<sup>72</sup> By contrast, giving the government a direct equity stake with special management rights in financial-service firms—that is, making the government a firm insider—would remove many of these legal and informational obstacles. As a special shareholder with uniquely tailored rights, the government would acquire the new capacity to take speedy and effective action necessary to counteract socially harmful, and thus irrational, effects of pure market rationality.

Without a doubt, the very idea of making the federal government a direct equity owner in private financial firms is likely to attract familiar criticisms as being too radical, unworkable, or even dangerous. Some of these criticisms may be simply variations on the familiar themes in reactionary rhetoric, so brilliantly described by Albert Hirschman.<sup>73</sup> At the same time, much like any innovative approach, this proposal poses a range of legitimately complex questions of legal doctrine, administrative design, and economic practicality. Without claiming to offer complete answers to all of those questions, this Article outlines the general contours of how we could potentially repurpose the golden share mechanism in order to ensure systemic financial stability and minimize the likelihood of financial crises.

### *B. SGS Basics: Substantive Mandate; Key Definitions*

The main operative provision of the federal statute establishing the new regime will mandate issuance by each “covered entity” of a single share of a special class—“state golden share” or “special government share” (in either case, SGS)—to be beneficially and legally owned, exclusively and at all times, by the federal government in its capacity as the “SGS Holder.” Statutory definitions of these terms form the basic operational framework for the proposed scheme.

#### *1. Covered Entity*

The definition of *covered entity* is essential to determining the jurisdictional scope of the SGS regime. As a matter of regime design, the initial choice is between (1) a broad base definition followed by specific carve-outs for certain types of financial institutions, and (2) a narrow, more

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*Complex Financial Products*, 90 WASH. U. L. REV. 63 (2012). See also Dan Awrey, *Complexity, Innovation, and the Regulation of Modern Financial Markets*, 2 HARV. BUS. L. REV. 235 (2012).

72. See Saule T. Omarova, *Wall Street as Community of Fate: Toward Financial Industry Self-Regulation*, 159 U. PA. L. REV. 411, 431–38 (2011).

73. See ALBERT O. HIRSCHMAN, *THE RHETORIC OF REACTION: PERVERSITY, FUTILITY, JEOPARDY* 7 (1991).

targeted definition, coupled with an explicit grant of regulatory discretion to broaden it in certain circumstances.

Under the first option, the statute will define *covered entity* very broadly, to include, for example, all financial institutions identified by their regulatory status as FDIC-insured depository institutions, bank holding companies, securities broker-dealers, and so on. To ensure that the definition does not inadvertently leave out other financial institutions, the statutory definition of *covered entity* could include a catch-all category of firms whose business activities are “predominantly financial” in nature—a familiar technique in U.S. laws governing financial institutions.<sup>74</sup> The statute could even simply define *covered entity* as any entity engaged in financial or “predominantly financial” in nature activities, without a reference to its regulatory status.

The main virtue of a broad definition of *covered entity* is its relative simplicity and the lower likelihood of leaving significant jurisdictional gaps in the regime. Its main drawbacks, however, are potential overinclusiveness and difficulty of administering in practice. The broader the jurisdictional scope of the SGS regime, and the greater the number and variety of firms subject to it, the more resource-intensive its practical implementation and enforcement are likely to be. To avoid potential inefficiencies of this kind, it will be necessary to supplement the general definition with a carefully crafted list of statutory exemptions. In effect, opting in favor of a broad default category of *covered entity* will push difficult line-drawing decisions into the exemption-drafting exercise.

For a more targeted application of the proposed regime, Congress may start with a narrowly drawn base definition of *covered entity*. For example, the new regime could be explicitly limited only to SIFIs. The statute could either (1) enumerate the criteria for determining systemic significance of any financial firm for the purposes of the SGS regime, or (2) incorporate by reference a particular definition of the concept under some existing law or regulation. Congress could also delegate the power to designate individual entities as systemically significant for the purposes of the statute to the regulators.<sup>75</sup>

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74. Financial laws and regulations often define the universe of firms subject to a particular set of rules by focusing on the nature of their primary business as financial service providers. There are various formulations of the nature-of-activities requirement (“substantially” financial, “predominantly” financial, etc.) and the specific criteria for determining whether a firm meets it. Typically, the rules focus on the composition of the company’s total consolidated assets, revenues, and income. *See, e.g.*, 12 U.S.C. § 5311(a) (2012).

75. Under the Dodd-Frank regime, the Financial Stability Oversight Council (FSOC) has the authority to designate a nonbank financial institution as a SIFI, which would make FSOC the natural candidate for the same task with respect to the SGS regime. *See, e.g.*, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21,637, 21,637–62 (Apr. 11, 2012) (to be codified at 12 C.F.R. pt. 1310).

The main benefit of this approach is that it would allow the government to concentrate its efforts only on firms determined to pose real risks to systemic stability. To the extent that going this definitional route will likely lower both the number of covered entities and the degree of variety among their business and risk profiles, it should render the new regime potentially easier to implement and administer. At the same time, however, the practical efficacy of a SGS scheme targeting specifically SIFIs will ultimately depend on the accuracy of that notoriously difficult judgment.<sup>76</sup> More generally, potential underinclusiveness is the principal drawback of this approach. To counter that danger, the statute may have to allow for some form of regulatory discretion to expand the universe of covered entities beyond the narrowly defined base category.<sup>77</sup>

Regardless of the chosen definitional approach, the statute should specify how it would treat large, diversified financial conglomerates combining numerous regulated financial intermediaries within a complex holding company structure. For the proposed regime to have any real systemic effect, it is critical that the government hold the golden share, or SGS, in the top-level holding company, where all strategic group-wide decisions are typically made and all group-wide data are aggregated and assessed. To avoid unnecessary duplication, it may make sense not to hold golden shares in subsidiaries of the same holding company. This approach may also be preferable as a scope-limiting device because it is based on organizational criteria rather than the qualitatively complex SIFI determination. If this approach is taken, however, it would be necessary to draft the statute and implementing regulations to preclude entity arbitrage designed to shift strategic information-gathering and decision-making functions into corporate layers below the top parent company.

## 2. *SGS and SGS Holder*

Technically, terms like *SGS* and *SGS Holder* can be defined simply by reference to the exclusive rights associated with that instrument, as set forth in the core substantive provisions of the statute. In that sense, these statutory terms are fundamentally derivative concepts that can be

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76. To date, FSOC has made only a few such official determinations, and MetLife, Inc.'s lawsuit against FSOC underscores how deeply politicized this process can be. See Andrew M. Harris & Katherine Chiglinsky, *MetLife Judge Called FSOC Review Process 'Fatally Flawed,'* BLOOMBERG (Apr. 7, 2016), <http://www.bloomberg.com/news/articles/2016-04-07/metlife-judge-found-fault-with-fsoc-too-big-to-fail-review>.

77. This raises an additional question of which government instrumentality should be authorized to exercise such discretion: FSOC, the SGS Holder, or some other regulatory body. For a discussion of this and other issues of regime administration, see *infra* Part IV.

understood only through an examination of how the SGS mechanism is intended to function.<sup>78</sup>

The core substantive element of the proposed SGS regime is the statutory delineation of the specific rights and obligations of the holder of the golden share, or SGS. Because SGS is a federally created instrument, its terms do not have to comply with the requirements of state corporate law, and its holder's rights and obligations can be vastly different from those of a regular corporate shareholder. At the same time, however, the proposed regime does not seek to convert any firm into a nationalized state-run enterprise. Therefore, the greatest challenge in designing the SGS is to find a proper balance of public and private interests within the context of a functioning economic enterprise.

In principle, the SGS is envisioned here as a dynamic mechanism, a sliding scale of management—and, under some circumstances, possibly some economic—rights triggered by specified events. The SGS should be viewed as a form of conditional (as opposed to absolute), temporary (as opposed to permanent), and calibrated (as opposed to uniformly predetermined) government control over the relevant covered entity's internal governance. To appreciate in full these essential attributes of the SGS regime, it is helpful to examine potential mechanics of its operation in each of its two principal modes: the passive “peacetime” mode and the active “emergency” mode.

### *C. The SGS Mechanism: The Passive Mode*

Unlike conventional shareholders, the SGS Holder would not have to make a capital contribution in exchange for its golden share and, generally, would not receive any dividends or distributions. The SGS can have a nominal value of \$1.00, at which it would be carried on the covered entity's balance sheet. Except as may be provided in the enabling statute, this nominally valued instrument would not entitle the government to any economic rights of a conventional shareholder, such as the right to receive dividends or distributions. This important feature distinguishes the proposed SGS mechanism from the more familiar instances of government acquiring control through purchase of a majority equity stake in a firm. Structuring the SGS as primarily, if not exclusively, a control instrument underscores its quasi-regulatory nature and highlights the government's role as a collective actor seeking to resolve certain market dysfunctions, as opposed to seeking pecuniary gains. However, if the government later

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78. A related but more complex issue of which specific government instrumentality will act as the SGS Holder with respect to all covered entities is discussed *infra* Part IV.A.

deems necessary to contribute capital to a covered entity, it could receive statutorily specified economic rights.<sup>79</sup>

Unless and until one or more of the specified triggering events happen, the SGS is meant to remain largely a passive instrument. In this “normal” period of dormancy, the SGS Holder would not be expected or entitled to exercise any direct management rights in the firm. Its rights would be primarily informational and representational in nature. It is crucial, however, that the SGS give its holder a broad right of direct and timely access to the firm’s internal information.

This, of course, raises the issue of balancing private firms’ right to preserve, within reasonable limits, confidentiality of their business information against the government’s right to know what it needs to know to protect the public from financial harm. Finding a workable balance of these two interests is by no means a simple task, but it may not be quite as difficult as financial institutions would like us to think. Financial institutions zealously guard their “proprietary” information, partly because they fear that competitors would copy or otherwise thwart their trading or investment strategies, and partly because opacity and complexity of their “branded” financial products effectively allow these institutions to extract monopoly rents.<sup>80</sup> However, the public interest here is compelling enough to be given a greater weight vis-à-vis this competitive obsession with secrecy.<sup>81</sup> The private firms’ interest, while subordinated in principle to the public interest, can be reasonably protected through carefully designed procedural mechanisms limiting the SGS Holder’s ability to use or disclose particularly sensitive trade information to other market participants. Thus, financial regulators routinely collect and review confidential firm information, and financial institutions themselves are routinely managing various internal informational walls mandated by regulation. The accumulated private and public arsenal of information-management techniques is a good starting point for crafting procedural confidentiality-protection rules under the SGS regime.

To perform its key informational and representational roles, the SGS Holder must have permanent representation on the covered entity’s board of directors. The enabling statute will need to mandate such permanent representation and then delineate the rights and duties of special SGS-

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79. For potential methods of calculating the government’s economic interest in such cases, see, for example, Jeffrey Manns, *Building Better Bailouts: The Case for a Long-Term Investment Approach*, 63 FLA. L. REV. 1349, 1383–97 (2011).

80. For an explanation of this phenomenon of “strategic complexity,” see Awrey, *supra* note 71, at 262–67 (2012); Omarova, *supra* note 71, at 68–75.

81. It is also subject to doubt how much “trade secrecy” there really is in the markets for financial products, especially given the constant cross-pollination of financial institutions’ personnel and clientele.

appointed directors (SGS directors), in line with the overarching objectives of the SGS regime.

A few basic considerations are worth emphasizing here.

The statutory notion of an SGS director is fundamentally different from the familiar corporate law device of an “independent” director. Independent directors are private parties appointed by shareholders and afforded a special place in the traditional corporate governance structure because of their presumed neutrality and objectivity, primarily inferred from their lack of direct financial interest in the firm. State and federal laws often mandate a specific number of such presumably more reliable independent directors to be appointed to boards or to specific board committees.<sup>82</sup> Yet, it is not entirely clear to what extent the appointment of independent directors improves the dynamics and outcomes of corporate decision-making in practice.<sup>83</sup> Ultimately, independent directors still owe a fiduciary duty to the corporation and its shareholders and are subject to the same standards of care and loyalty as insider directors.<sup>84</sup>

By contrast, SGS directors are representatives of the U.S. government (and employees of the federal entity that acts as the SGS Holder). The statute would specify that their primary fiduciary duties run explicitly to the taxpaying American public. The specific number of individual SGS directors to be appointed in any particular case would depend on the individual profile, size, and other relevant circumstances of each covered entity. The statutory goal here is not to have a majority—or even a “critical mass”—of government-appointed directors on the board but to have a *special class* of directors with special class-specific rights that, under certain circumstances, may override purely numeric voting outcomes.

In this respect, it is critical to grant SGS directors enhanced rights to request any additional information from the firm’s management or agents, if necessary to enable them to fulfill their duties.<sup>85</sup> Importantly, the statute should expressly prohibit covered entities from taking any action whose intended or unintended effect would be to limit SGS directors’ access to information or participation in the decision-making process.

It may also be desirable to grant SGS directors certain “baseline” special voting rights that remain in effect at all times, even when the SGS is otherwise “dormant.” As discussed above, one of the defining features of the traditional golden share mechanism is the special supermajority voting power that effectively allows the government shareholder to veto any

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82. See Karmel, *supra* note 45.

83. *Id.*

84. See *supra* Part I.A.

85. To the extent the SGS directors are “insiders” of the relevant firm, the firm’s lawyers’ duty of confidentiality should not prevent them from providing requested information to the firm’s SGS directors. To strengthen this point, the SGS statute could include a specific provision to this effect.

corporate decision involving matters of special public policy concern.<sup>86</sup> In a similar vein, the SGS statute may require the SGS directors' affirmative approval of certain important corporate decisions that potentially have a bearing on matters related to systemic financial stability. For example, the SGS directors' approval could be required whenever the covered entity's board of directors approves the management's strategic business plan or the firm's risk management policy, approves an executive compensation program, or appoints external auditors.<sup>87</sup>

To ensure the SGS directors' continuous access to vital intrafirm information and to enhance their practical ability to exercise their decision-making rights in a meaningful manner, it would be advisable to mandate that the SGS directors have designated seats on the Risk Management Committee and the Audit Committee of the relevant covered entity's board of directors. Being a member of these particular committees is the best and fastest way for the SGS directors to gain a deeper understanding of the firm's business and overall risk culture. The knowledge acquired in this process would be an invaluable asset to the SGS directors in the performance of their statutory duties.

In short, the principal function of SGS directors is to be our collective eyes and ears on financial institutions' boards, the embodiment of the government-as-market-actor striving to correct private markets' potentially destabilizing and socially destructive "natural" tendencies.<sup>88</sup> Furthermore, adding SGS directors to covered entities' boards is likely to have a deeply transformational impact on these entities' key internal processes and norms. Among other things, it is reasonable to expect that their watchful presence and explicitly systemic perspective would significantly improve boardroom dynamics and alter the balance of power between financial firms' boards of directors and managers. It is difficult to overestimate the importance of this factor for altering banks' and other SIFIs' currently prevailing—and problematic—risk culture in publicly beneficial ways.<sup>89</sup>

In order to deliver these intended benefits, however, the SGS regime must introduce a sufficiently strong incentive for financial firms to take their SGS directors seriously even when the latter are performing their passive peacetime duties. The most powerful incentive in this respect is the threat of triggering the SGS Holder's special rights as the firm's manager of last resort.

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86. *See supra* notes 66–70 and accompanying text.

87. It is important to build some flexibility into this framework, giving the government entity acting as SGS Holder the necessary discretion to determine which matters are significant enough to require SGS directors' review and pre-approval, based on a particular covered entity's business/risk profile, systemic footprint, or any other relevant considerations.

88. *See supra* Part I.B.

89. *See supra* note 7 and accompanying text.

### III. THE GOLDEN SHARE IN ACTION: THE “MANAGER OF LAST RESORT”

This Part focuses on the operation of the proposed SGS regime in its “active” mode, when certain firm-specific or systemic factors necessitate a shift in the principal role of the SGS Holder from that of an observer to that of an emergency manager of the covered entity.

#### A. *Activating SGS: Triggering Events*

The occurrence of specified events would trigger additional special rights of the SGS Holder. In effect, statutory “triggering” events would *activate* the SGS Holder’s direct management rights, shifting the entire mechanism from its relatively passive peacetime state into the actively participatory “high-alert” phase. While this Article does not purport to provide a precise list of statutory triggers and corresponding SGS rights, it is helpful to outline some of the potentially relevant considerations.

As a general matter, statutory SGS triggers should be tied to the regime’s main policy objective: preserving systemic financial stability and preventing excessive accumulations of systemic risk in the financial sector. Therefore, special management rights of the SGS Holder should be activated in response to certain internal and external signals indicating a potentially greater likelihood of increasing systemic risk or instability. Some of the familiar regulatory and supervisory metrics—such as capital adequacy levels, supervisory ratings, or stress test results—can serve as proxies for triggering additional SGS rights.<sup>90</sup> Another category of firm-specific SGS triggers would encompass significant weaknesses or lapses in a covered entity’s legal and regulatory compliance, financial reporting, or internal risk management—particularly if not uncovered, reported, and preventatively corrected internally.<sup>91</sup>

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90. Incorporating these firm-specific metrics into the SGS regime would necessitate establishing regular channels of communication and coordination—as well as clearly delineated spheres of jurisdictional authority—between the SGS Holder and state and federal financial regulators. *See infra* Part IV.A.

91. Obvious cases of legal misconduct or regulatory violation—such as, for example, participation in a price-rigging scheme or fraudulent accounting practices—would trigger the additional SGS rights. Real-life examples of such instances include scandals involving LIBOR and foreign exchange rates manipulation, as well as “robo-signing” and other illegal home-loan foreclosure practices of large U.S. banks. Under the proposed regime, a particular firm implicated in, or subject to investigation in connection with, any such scandal would risk immediate triggering of additional SGS management rights. However, the SGS rights may also be triggered in response to a series of less egregious violations that may nevertheless indicate a troublesome pattern of the management’s failure to ensure compliance with laws and regulations. An example of such a pattern is Citigroup’s infamous string of regulatory failures in 2004–2005, which led the Federal Reserve to impose a temporary moratorium on the company’s acquisitions. *See* Arthur E. Wilmarth, Jr., *Citigroup: A Case Study in Managerial and Regulatory Failures*, 47 *IND. L. REV.* 69, 71 (2014).



Another critically important, while also difficult to define with precision, group of SGS triggers would include signs of certain troubling trends in a particular covered entity's business strategy and overall risk appetite. For example, in a proposed scheme, special SGS rights can be triggered by a potentially problematic shift in a covered entity's business and risk profile, as a result of either acquisition-driven growth or internally driven changes in the composition or nature of its assets and liabilities. Some of the potential indicators here may include a sudden or rapid growth of particular asset categories in a covered entity's or its key subsidiaries' portfolios (e.g., certain types of asset-backed securities or physical commodities), a discernible increase in the volume or riskiness of certain types of off-balance-sheet transactions (e.g., credit default swaps), or rising levels or changing tenor of the company's or its key subsidiaries' liabilities (e.g., increased reliance on borrowing in wholesale securities repurchase markets).

Size-related metrics may be particularly useful as potential triggers. Size remains one of the key factors determining the level of systemic significance of an individual financial institution.<sup>92</sup> Therefore, it would make sense to condition the scope of the SGS Holder's systemic risk-minimizing powers on the size of a covered entity, measured either in absolute (a specific quantitative threshold) or relative terms (e.g., market share or rate of increase in size over a certain period of time). The logic is simple: the bigger the firm, the bigger its systemic footprint, the higher the potential public costs of its failure—and so the greater the need to have direct public say in its affairs. Accordingly, an absolute quantitative size trigger should be set at the level that would automatically pick up all of the existing large financial groups that are potentially “too big to fail” (TBTF). SGS Holder's broader and more direct powers over the management of TBTF firms would function, in part, as a substitute for weakened external market discipline and, in part, as a corrective internal systemic-vision lens. Moreover, the threat of potentially very intrusive governmental “meddling” in large firms' internal business affairs may operate as a significant deterrent against becoming TBTF.

In addition to firm-specific triggers, it is important to ensure that the SGS mechanism is responsive to external signals of potentially troubling systemic imbalances or vulnerabilities in the financial markets. Thus, enhanced SGS rights might be triggered simultaneously across all covered

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92. Thus, under the Dodd-Frank Act and implementing regulations, financial institutions with more than \$50 billion in total consolidated assets are generally presumed to be systemically important. Nonbanking financial companies that meet this size threshold are further evaluated for systemic significance based on a mix of quantitative and qualitative criteria. *See, e.g.*, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21,637, 21,659 (Apr. 11, 2012) (to be codified at 12 C.F.R. pt. 1310).

entities—or their relevant subset—by sudden accelerations in credit growth across the financial system, which may indicate excessive buildup of risk and leverage feeding a speculative asset bubble. The government could arrest this potentially destabilizing systemic trend by exercising its special SGS rights to either veto or slow down certain kinds of lending and borrowing activities pursued by individual covered entities. For example, in the context of a nascent system-wide credit bubble, the SGS Holder could demand that individual covered entities raise more equity as a condition to continuing their lending activities—a demand that could also be framed as a conditional promise to refrain from exercising the SGS Holder’s relevant veto rights. This would, in effect, function as an internal governance mechanism for so-called dynamic provisioning, or building countercyclical capital buffers at financial firms: when the credit is plentiful and the economy is in an expansionary mode, financial institutions would be forced to reduce their leverage.<sup>93</sup> Building external triggers into the SGS mechanism, therefore, would enhance its utility as an important complement to the government’s efforts to preserve systemic financial and economic stability through regulation.

In general, defining and applying SGS triggers is a challenging and highly context-specific exercise that requires an individualized assessment of all relevant factors. It is, therefore, critical to allow the SGS Holder a significant degree of discretion in deciding when exactly its special rights should be triggered, and how exactly they should be used. Of course, this grant of discretion must be carefully contained to ensure there is a sufficient degree of public accountability.<sup>94</sup> The enabling statute will need to provide both a clear normative basis for the exercise of discretion and a robust procedural framework for making entity-specific SGS trigger determinations.

As a normative matter, unambiguously articulating in the statute the key policy goals that the SGS regime is designed to serve—preserving long-term stability of the U.S. financial system and preventing potentially destabilizing accumulation of risk in the financial sector— would go a long way toward establishing guidelines for the exercise of discretion by the SGS Holder. Due to the inherent difficulty of correct and timely recognition and interpretation of market signals, it is also important to introduce an explicitly precautionary principle into this exercise.<sup>95</sup> Although adopting a precautionary stance may result in less precise, blunter criteria for triggering additional SGS rights, an alternative approach

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93. For a discussion of countercyclical capital buffers, see Brett H. McDonnell, *Designing Countercyclical Capital Buffers*, 18 N.C. BANKING INST. 123 (2013).

94. For a discussion of some such accountability mechanisms, see *infra* Part IV.B.

95. For a discussion of the role of precautionary principle in financial services regulation, see Hilary J. Allen, *A New Philosophy for Financial Stability Regulation*, 45 LOY. U. CHI. L.J. 173 (2013).

advocating a tightly limited statutory definition of each SGS triggering event—and, thus, prospectively limiting the circumstances in which the government can exercise its full SGS rights—potentially threatens to undermine the efficacy of the SGS mechanism.

As a procedural matter, the statute could enumerate the key factors that the SGS Holder either “must” or “may” take into account in making its determination that a specific triggering event had occurred.<sup>96</sup> The statute would also specify basic procedures for internal and external vetting of such determinations. Internal rules would specify the timing and format of the intra-agency process, which would presumably be initiated by the affected firm’s SGS directors and then approved, with any necessary modifications, by a special agency committee. Externally, the statute would specify the timing and nature of communication and coordination between the SGS Holder and other federal regulators—including, most importantly, FSOC and the Federal Reserve. It is critical, however, that these procedural rules do not operate to create undesirable delays or otherwise inhibit the SGS Holder’s ability to take necessary actions.

### *B. The SGS Mechanism: The Active Mode*

So, what are some of these special SGS rights that are triggered by these various events? Essentially, a triggering event ends the passive or “dormant” state of the SGS and shifts it into the active or high-alert mode, in response to firm-specific or market-wide signals of potential increase in the level of systemic risk. At that point, the government essentially assumes its (temporary) new role as the manager of last resort.

In this active mode, the SGS Holder would have broad veto powers allowing it to block any decision by a covered entity’s board of directors or shareholders. This broad statement of the SGS veto right is based on a common sense understanding that the government should not—and, realistically, is highly unlikely to—exercise its broad veto rights indiscriminately. The idea behind this broad formulation is to give the government the necessary flexibility to take whatever measures are called for under the circumstances. To this end, the statute would grant the SGS Holder an express right to call shareholder meetings and to propose specific agenda items for such meetings. The statute may also grant the SGS Holder supermajority voting power, but only with respect to matters expressly

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96. This is a well-established method of providing congressional guidance to U.S. financial regulators exercising their discretionary powers. See generally Hester Peirce, *Economic Analysis by Federal Financial Regulators*, 9 J.L. ECON. & POL’Y 569 (2013).

determined by the SGS Holder to be critically important for the preservation of the long-term stability of the U.S. financial system.<sup>97</sup>

As a practical matter, the SGS Holder will exercise its post-trigger rights through the relevant firm's serving SGS director(s). The occurrence of a statutory triggering event, in effect, transforms the primary role of an SGS director from that of an observer, monitor, and provider of a systemic perspective—for the most part, remaining in the background—to that of the key decision maker. At this stage, the SGS directors would take effective control of the board's actions. The precise extent, nature, and mechanisms of control would depend on the nature and severity of the SGS-triggering concerns and other relevant circumstances of each particular case.

Generally, however, the SGS directors would have a right to impose temporary moratoria on shareholder distributions and major corporate transactions. They would also have a right to suspend or remove any manager or officer of the firm.<sup>98</sup> The SGS directors would be empowered to call special meetings of the board of directors and to propose specific agenda items or resolutions, or both, for the board's vote.<sup>99</sup> For instance, depending on the circumstances that triggered special SGS rights with respect to a particular covered entity, the SGS directors could propose board resolutions halting specific high-risk trading or investment activities, reducing the firm's risk exposure by selling certain assets or unwinding trading positions, revising internal policies and procedures governing activities in question, raising more equity and reducing the firm's leverage, suspending or replacing individual managers or executive officers, and engaging outside counsel to advise the firm on improving its internal regulatory compliance and risk management functions.

If these measures prove insufficient to resolve and prevent likely recurrence of the firm's problems, the SGS directors could propose to the board a resolution mandating sale of certain subsidiaries or segments of the firm's business—a measure that could effectively break up a TBTF firm. If, on the other hand, the less drastic corrective measures work, so that the degree of systemic risk posed by the covered entity's activities is reduced below the statutory trigger level, the SGS should revert to the pre-trigger,

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97. As is the case with the determination of the occurrence of a triggering event, the statute would have to establish certain substantive and procedural guidelines that the SGS Holder, or any of its agents, must follow in making the required determination of "critical importance." See *supra* notes 95–96 and accompanying text.

98. Depending on the nature or degree of egregiousness of misconduct, the SGS directors would have the right to petition relevant regulatory authorities to consider appropriate sanctions against individual managers or officers.

99. Again, it may be desirable to grant the SGS directors supermajority voting power with respect to matters expressly determined to be critically important for the preservation of long-term stability of the U.S. financial system, as provided in the enabling statute. See *supra* note 97 and accompanying text.

dormant state and the SGS directors should relinquish their special rights.<sup>100</sup>

To be able to discharge their newly elevated responsibilities, the SGS directors should be authorized to make certain necessary changes in the covered entity's internal organizational structure. That includes, for example, reordering the chain of command within the firm so that certain key audit, legal, risk management, compliance, or any other personnel—including managers of trading desks and other front office operations—work directly with, and report directly to, the SGS directors or their designated support staff.<sup>101</sup> This “commandeering” of the firm's employees would be easier to achieve if the SGS directors establish direct lines of communication with certain key personnel during the pre-trigger dormant period.<sup>102</sup>

It is important to emphasize, however, that the ultimate goal of the proposed regime is not to put the federal government in charge of private firms but, to the contrary, to minimize the need to trigger the SGS Holder's special management rights in practice. An effective SGS regime should create strong and concrete ex ante incentives for the covered entities' shareholders, directors, and managers to act in a way that reduces, rather than increases, the potential negative impact of their firms' business operations on the ability of the broader financial system to support and stimulate real economic growth. An unambiguously formulated threat of drastically, if only temporarily, limiting these traditional corporate actors' control over their firms' business decisions would fundamentally reshape the context in which covered entities raise capital and make investments. Once investors have a strong incentive to price correctly the risk of an SGS triggering event into their valuations of a specific covered entity, it would put continuous pressure on the management to monitor and enforce proper internal risk tolerance limits at every level of the firm. In that sense, the

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100. The statute would have to establish special procedures and basic policy guidelines for making this necessarily context-specific determination. These special, enhanced SGS rights are not designed to give the government permanent control over management of a private financial services firm. The goal here is to enable the government to intervene into the affairs of a specific firm acting in a systemically harmful way, and do so at an early stage when internal corrections can still be made and control can be returned to its own management. To ensure that this control reversion doesn't happen prematurely, however, the SGS Holder's decision to put the SGS “back to sleep” would have to be supported, reasoned, and properly documented.

101. There are, of course, various questions regarding support staff for the SGS directors: who should be hiring them and paying their salaries, how many of them should be hired, etc. These are important but by no means critical details for present purposes.

102. It is reasonable to expect that, in performing their general monitoring duties, the SGS directors would build close working relationships with each covered entity's audit, legal, compliance, and risk management departments. In fact, the very presence of the SGS directors on the firm's board, even if in a relatively passive capacity, is likely to boost the relative power and independence of the firm's legal and regulatory compliance managers by giving them an external source of support and often the necessary “cover” for their actions.

SGS regime would perform the indispensable role of a “well oiled” “shotgun . . . behind the door,”<sup>103</sup> which is there as a reminder of the public’s power to protect its legitimate interests—and to make the abstract notion of market discipline far more real than it currently is.<sup>104</sup>

#### IV. INSTITUTIONAL DESIGN: KEY CONSIDERATIONS

One of the critical factors in determining potential efficacy, or even desirability, of the proposed SGS mechanism is the identity of the SGS Holder and its place within the overall organizational structure of the U.S. government. How much trust we, the taxpaying American public, put into the new golden share mechanism depends greatly on *who* exercises the powers it creates—and *how effective* that entity is likely to be in performing such an important and complex task.

To be effective, the new entity—the SGS Holder—would have to satisfy several key requirements. First of all, the SGS Holder has to have sufficient technical expertise to be able to understand and manage large financial institutions. Secondly, it has to have a strong sense of public mission and be able to resist all forms of “capture” by private interests.<sup>105</sup> Finally, the SGS Holder has to be sufficiently insulated from political influence, while also publicly accountable for its actions.

Designing a new regime that successfully meets these standards is a challenging task, but it is neither new nor unique to this proposal. Any attempt to establish effective public oversight of financial markets inevitably raises these same issues. Not surprisingly, the latest crisis reinvigorated scholarly debate on potential methods of reducing the distortion of financial regulators’ incentives as a result of undue influence of private interests. Many proposed solutions focus on regulatory agencies and offer ways to insulate their decision-making from direct political interference by Congress or a presidential administration,<sup>106</sup> to increase

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103. William O. Douglas, *Reorganization of the New York Stock Exchange* (May 20, 1938), in *DEMOCRACY AND FINANCE: THE ADDRESSES OF WILLIAM O. DOUGLAS* 82 (James Allen ed., 1969).

104. On the systematic failures of “market discipline” in the absence of an effective extra-market disciplining device, see generally Min, *supra* note 1.

105. Regulatory capture is a complex phenomenon that encompasses ideological, or cultural, capture. See, e.g., James Kwak, *Cultural Capture and the Financial Crisis*, in *PREVENTING REGULATORY CAPTURE: SPECIAL INTEREST INFLUENCE AND HOW TO LIMIT IT* 71 (Daniel Carpenter & David A. Moss eds., 2014) (introducing and examining the concept of “cultural capture” as a channel of improper industry influence over financial regulators); Simon Johnson, *The Quiet Coup*, *ATLANTIC* (May 2009), <https://www.theatlantic.com/magazine/archive/2009/05/the-quiet-coup/307364/> (arguing that the financial industry over time successfully shaped both technical and normative views of the regulators who came to share the industry’s version of a public good).

106. See Rachel E. Barkow, *Insulating Agencies: Avoiding Capture Through Institutional Design*, 89 *TEX. L. REV.* 15 (2010); Lisa Schultz Bressman & Robert B. Thompson, *The Future of Agency Independence*, 63 *VAND. L. REV.* 599 (2010).

transparency of regulatory decision-making and agency accountability,<sup>107</sup> to strengthen the agencies' internal subject-matter expertise by increasing compensation of agency employees and creating an elite professional culture among them,<sup>108</sup> or to institutionalize “contrarian” thinking inside regulatory agencies.<sup>109</sup> There is, therefore, a potentially rich source of helpful ideas to inform the search for an optimal organizational design for the SGS regime—a task that lies beyond the scope of the current thought experiment.

For present purposes, the focus is on a few key design issues: the choice of organizational form of the SGS Holder; the new entity's place in the existing regulatory architecture; the source of funding for its activities; and potential ways of ensuring its public accountability.

#### *A. Organizational Choices; Place in the Regulatory Structure*

With respect to organizational form, there are two principal options. First, Congress may choose to vest the SGS Holder responsibilities in one of the existing financial regulators, such as the Federal Reserve or FDIC. This approach may be attractive as a matter of logistics or politics, since it avoids creating a brand new agency. However, adding a special-shareholder role to the Federal Reserve's or FDIC's existing regulatory functions could create at least an appearance of significant conflicts of interest and potentially undermine credibility and efficacy of the SGS regime. Moreover, each existing agency's established culture, with its own internal peculiarities and dysfunctions, is likely to “infect” the new SGS corps and dilute its emerging sense of mission.

Alternatively, Congress may establish either a new federal agency or a federally chartered government corporation—or both—to act as the exclusive SGS Holder with respect to all covered entities. The choice

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107. Thus, one of the most heated postcrisis debates focused on the secretive nature of the Federal Reserve's decision-making process. See, e.g., Lawrence G. Baxter, “Capture” in *Financial Regulation: Can We Channel It Toward the Common Good?*, 21 CORNELL J.L. & PUB. POL'Y 175 (2011).

108. See, e.g., Lawrence G. Baxter, *Capture Nuances in Financial Regulation*, 47 WAKE FOREST L. REV. 537 (2012). The issue of compensation is extremely important in designing the SGS regime. To ensure that the new regime employs highly knowledgeable and capable individuals, they would have to be offered salaries comparable to what they would get paid in the private sector. Purely from an organizational-design perspective, this factor works strongly in favor of structuring the SGS Holder as a federal government corporation rather than a regulatory agency. Among other things, specially chartered government corporations may be (and often are) exempt from the typical budgetary controls and statutory ceilings on employee compensation. See KEVIN R. KOSAR, CONG. RESEARCH. SERV., RL30365, FEDERAL GOVERNMENT CORPORATIONS: AN OVERVIEW (2011); KEVIN R. KOSAR, CONG. RESEARCH. SERV., RL30533, THE QUASI GOVERNMENT: HYBRID ORGANIZATIONS WITH BOTH GOVERNMENT AND PRIVATE SECTOR LEGAL CHARACTERISTICS (2011).

109. See Brett McDonnell & Daniel Schwarcz, *Regulatory Contrarians*, 89 N.C. L. REV. 1629 (2011).

between a federal agency and a government corporation has significant consequences. The U.S. federal government has a long history of chartering special government corporations, many of which operate under a unique set of privileges and constraints.<sup>110</sup> Potential flexibility with respect to crafting such special privileges and constraints weighs strongly in favor of chartering the SGS Holder as a government corporation.<sup>111</sup>

To enable the new entity to perform its functions successfully, it is important to structure its relationships with other financial regulators—including the Federal Reserve, FDIC, Office of the Comptroller of the Currency, Securities and Exchange Commission, Commodity Futures Trading Commission, and the Consumer Financial Protection Bureau—in a carefully balanced manner. On the one hand, the SGS Holder must maintain close working contact with the relevant regulatory and supervisory agencies, especially to the extent such agencies are charged with systemic, macroprudential oversight. Mutual information-sharing and agency coordination are indispensable for the new scheme to work effectively.<sup>112</sup> In addition to regular interagency discussion meetings, it may be desirable to ensure the SGS Holder's ability to access supervisory information, both on a firm-specific and aggregate basis, upon request. In particular, SGS directors should be able to participate in the process of supervisory reviews, to the extent necessary, and have separate channels of communication with the relevant firm's examiners.

On the other hand, however, the SGS Holder cannot become simply another traditional regulator—the new entity must retain its distinctive

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110. See *Lebron v. Nat'l R.R. Passenger Corp.*, 513 U.S. 374 (1995) (describing the history of Amtrak and other government-chartered corporations). For academic analyses of the functions and varied organizational structures of government corporations and quasi-governmental entities, see A. Michael Froomkin, *Reinventing the Government Corporation*, 1995 U. ILL. L. REV. 543 (1995); Anne Joseph O'Connell, *Bureaucracy at the Boundary*, 162 U. PA. L. REV. 841 (2014); Benjamin A. Templin, *The Government Shareholder: Regulating Public Ownership of Private Enterprise*, 62 ADMIN. L. REV. 1127 (2010).

111. Among other things, this option would (1) allow the SGS Holder to offer salaries in excess of the federal-employee compensation limits and, thus, attract and retain highly qualified personnel; (2) potentially free it from many of the formal constraints and requirements of the administrative process; (3) give it a greater degree of insulation from direct political pressure; and (4) encourage the emergence of a more focused and mission-oriented institutional culture. See sources cited *supra* note 108. The principal downside of this option is the potential loss of, or an ambiguity with respect to, federal immunity. To solve or preempt this problem, the SGS statute would have to include explicit provisions shielding the SGS Holder and individual SGS directors from potentially crippling shareholder suits. For a discussion of such provisions, see *infra* Part IV.B.

112. As discussed above, regular and effective information-sharing and coordination with the regulatory and supervisory agencies are particularly important in facilitating the SGS Holder's determination of whether a statutory triggering event has occurred with respect to a particular covered entity. See *supra* Part III.A.



market-actor, firm-insider focus and identity.<sup>113</sup> The SGS Holder's most significant decisions should reflect its primary mission to act as a direct stakeholder in a private firm, using internal levers of corporate governance to achieve the public goal of correcting individual firms' potentially systemically destabilizing behavior. Even when other regulatory agencies pursue the same general goal of preventing systemic instability, their typical methods and general posture vis-à-vis regulated firms are fundamentally different. The SGS Holder's decisions, while informed by the relevant regulators' actions and opinions, must nevertheless retain their "genetic code" as market-driven decisions, especially since the SGS Holder's actions aim ultimately at preserving the market from self-destruction. Otherwise, not only the legitimacy<sup>114</sup> but also the very efficacy of the SGS mechanism may be compromised.<sup>115</sup>

For example, the SGS Holder's expanded role in the active post-trigger stage may be seen as excessively overlapping with the FDIC's and other bank regulators' rights under the existing regime of prompt corrective action (PCA).<sup>116</sup> The PCA regime establishes a scale of increasingly intrusive regulatory restrictions on the ability of the board of directors and management of a troubled bank to take various corporate actions—e.g., distributing dividends to shareholders or making acquisitions—that could hasten its bankruptcy. It functions as an early warning system that forces regulators to adopt a quasi-managerial stance with respect to banks facing potential failure. As discussed above, the regulatory and supervisory metrics that trigger various PCA responses can also be used to trigger special SGS management rights.<sup>117</sup> Nevertheless, the SGS regime is not a substitute for, or a redundant replication of, the PCA scheme. Thus, the former is potentially significantly broader in its scope, both because its explicit goal is the preservation of systemic financial stability and because

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113. Again, this need to establish a distinctive identity of the SGS Holder as a market actor, as opposed to a regulator or supervisor, works in favor of establishing it as a federally chartered government corporation. *See supra* note 111.

114. One of the expected criticisms of the SGS proposal could point to potential conflicts of interest by virtue of the government acting both as a sovereign and a shareholder in financial firms. Although frequently overstated, it is a legitimate concern that requires special attention to avoiding or minimizing not only actual but also apparent conflicts of interest in the operation of the SGS regime. Designing an institutional structure and providing a clear and transparent procedural framework for the SGS Holder's decision-making are of paramount importance in this respect.

115. Generally, there is an inherent difficulty in discussing the efficacy/feasibility aspect of any new proposal simply because, in reality, much will depend on the culture of the new agencies and personalities of individuals who would lead them. Who these people are, how smart and honest they are, and how seriously they take their public duties will make all the difference in making the SGS idea succeed or fail in practice. None of that can be theorized or "proven" in the abstract. By the same token, of course, it cannot be theoretically "proven" that the proposed regime will necessarily fail for the lack of the right people or the right mindset.

116. *See* 12 U.S.C. § 1831o (2012).

117. *See supra* note 89 and accompanying text.

the universe of covered entities is likely to extend beyond FDIC-insured depository institutions.<sup>118</sup> Even more importantly, the SGS Holder will have a unique set of internal governance tools at its disposal, potentially enabling it to target the individual firms' problems more effectively, in a flexible and timely fashion. In effect, a well-functioning SGS regime may reduce the need to use the more intrusive among the PCA tools—and possibly to place troubled firms in resolution—by shifting the burden of timely risk prevention and correction back on the relevant firm's directors and managers whose actions (or inactions) allowed such risk creation in the first place.<sup>119</sup> Of course, regular and close information-sharing and coordination between the SGS Holder and FDIC are crucial to ensuring that these two parallel processes operate in a mutually enhancing, rather than inefficiently duplicative, way: one working from within, and the other from outside the troubled firm.

Furthermore, in contrast to PCA or other traditional tools of bank supervision, the SGS regime would be uniquely designed to utilize mechanisms of internal corporate governance in response to the early signs of systemic risk accumulation on a macro, as opposed to micro, level. Thus, as discussed above, the SGS special management rights can be activated if the SGS Holder identifies potentially destabilizing market or industry trends, even if there are no immediate signs of weakness at the level of an individual covered entity.<sup>120</sup> This type of proactive correction of systemic imbalances through adjustments to individual firms' behavior would serve as an invaluable supplement to the government's current inventory of macroprudential regulation.

To take full advantage of this vital benefit of the proposed SGS regime, it would be necessary to ensure that the SGS Holder maintains constant communication and works closely with both FSOC and the Office of Financial Research (OFR) of the U.S. Treasury Department.<sup>121</sup> To the

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118. *See supra* Part II.B.

119. The same potential benefit also obtains with respect to the postcrisis SIFI resolution regime under the Orderly Liquidation Authority (OLA). *See* Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 201–217, 12 U.S.C. §§ 4403, 5381–5394 (2012), 18 U.S.C. § 1032 (2012). Discussing the controversies surrounding the practical implementation and potential efficacy of SIFI resolution under the Dodd-Frank regime is beyond the scope of this Article. It is worth emphasizing here, though, that the SGS regime potentially provides a much more flexible, broader in scope, and far less procedurally cumbersome alternative to SIFI resolution or liquidation. In that sense, it is likely to be a more effective potential means of avoiding politically unpopular bailouts of large financial institutions.

120. *See supra* Part III.A. An example of a potentially troublesome market trend would be a sudden rise in the price of a particular type of financial instrument, such as mortgage-backed securities. An example of a potentially troublesome industry trend would be a sudden or rapid growth in assets or leverage of a specific category of financial institution, such as mortgage lenders.

121. Under the Dodd-Frank regime, the OFR's mission is to provide research and informational support for FSOC and other financial regulators specifically for purposes of detecting, measuring, and monitoring systemic risk. *See About the OFR*, OFF. OF FIN. RES., [www.financialresearch.gov/about/](http://www.financialresearch.gov/about/).

extent that neither FSOC nor OFR have actual supervisory responsibilities, their relationship with the SGS Holder would be explicitly focused on tracking and analyzing key system-wide dynamics. The head of the SGS Holder should have a place on FSOC, even if in a special capacity as an observing member (in order to preserve the SGS Holder's autonomy and identity as a market actor). The SGS directors may be explicitly allowed to solicit information and advice from the OFR personnel and to give such information or advice a significant weight in making their firm-specific decisions. It may also be desirable to establish regular OFR briefings for the entire corps of SGS directors.

### *B. Funding; Accountability Mechanisms*

Proper funding is another important factor in ensuring the level of operational and decision-making autonomy vital to the efficient functioning of the new SGS regime. To perform its hybrid role as a public market actor effectively, the SGS Holder would need to attract and retain highly qualified and committed personnel, which requires not only sufficiently high levels of compensation but also considerable ongoing investment in employee training and organization building. Since the proposed SGS regime is not designed to generate any financial profit for the federal government, it would be critical to secure a reliable source of funding other than discretionary congressional appropriations.

In principle, the SGS Holder could be funded by earmarking a portion of the Federal Reserve's revenues. Another potential source of the SGS Holder's funding could be some sort of an industry surcharge, applicable either to all financial services firms (on a sliding scale, depending on the firms' size or systemic significance) or to some subset of such firms.<sup>122</sup> A market-wide "financial transactions tax"<sup>123</sup>—a popular, though controversial, idea—could also be used to fund the SGS Holder's operations, at least in part. Finally, the function of an SGS Holder could be vested in a public instrumentality—which could be a federal agency or a government corporation—that performs other market-actor roles as well and, as a result of such additional operations, generates its own revenues.<sup>124</sup>

The uniquely hybrid nature of the SGS regime also raises potentially complex issues of designing effective procedural tools for ensuring a reasonable degree of transparency and public accountability—while, at the

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122. This subset could include, for example, all federally insured institutions, all BHCs, and all nonbank institutions that either exceed a certain size threshold or meet other regulatory criteria for potential systemic significance.

123. See Ross P. Buckley, *Reconceptualizing the Regulation of Global Finance*, 36 OXFORD J. LEGAL STUD. 242 (2016).

124. See *Public Actors*, *supra* note 13, at 173.

same time, preserving the SGS Holder's ability to react quickly and to take a wide range of actions shielded from public view by the corporate entity's organizational walls. In devising such tools for the SGS regime, one may be able to draw on a variety of existing examples, both in financial regulation and in other regulatory areas. Thus, as discussed above, building into the SGS regime a series of mandatory interagency coordination requirements would provide an important channel for the external vetting of the SGS Holder's most significant firm-specific determinations.<sup>125</sup> In addition, it may be desirable to establish some form of oversight of the SGS Holder's operations by FSOC, as the principal U.S. systemic-risk monitor. To avoid potentially excessive interference in the substance of the SGS Holder's decision-making process, however, it may be advisable to limit FSOC's oversight authority to certain procedural matters. Furthermore, the statute could mandate that the head of the SGS Holder submit annual reports to Congress outlining its principal actions in the relevant period and providing its overall assessment of key trends in the U.S. financial system.<sup>126</sup> The statute could also require periodic audits of the SGS Holder by an audit panel specially appointed for that purpose by FSOC. Finally, it may be desirable to establish a special advisory body comprising independent experts and public interest advocates, whose primary function would be to guard not only against potential abuses of the SGS Holder's statutory powers but also—and very importantly—against potential failures on the part of that entity to fulfil its statutory mandate.<sup>127</sup>

An important aspect of accountability, both in the realm of government decision-making and in the traditionally private sphere of corporate governance, is the availability of judicial review of decision makers' actions. In the context of the SGS proposal advanced here, one of the most delicate issues concerns the relative rights of private shareholders in covered entities vis-à-vis the SGS Holder. A similar issue arose in the context of the federal government's acquiring direct ownership stakes in firms that received emergency equity investments under the Troubled Asset Repurchase Program initiated by the U.S. Treasury in the fall of 2008.<sup>128</sup> This crisis-driven measure raised difficult questions regarding the availability of judicial and administrative review of the government's actions in its new capacity as a controlling shareholder. Predictably,

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125. See *supra* Part III.

126. The statute may also require the SGS Holder to submit copies of its annual congressional reports to the FSOC, Federal Reserve, and the Treasury Department.

127. For more on designing an independent public advisory body of this type, see Saule T. Omarova, *Bankers, Bureaucrats, and Guardians: Toward Tripartism in Financial Services Regulation*, 37 J. CORP. L. 621 (2012).

128. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (2008) (codified as amended in scattered sections of the U.S. Code).

corporate law scholars stressed the importance of protecting private shareholders against the government-shareholder's politically driven actions that could negatively affect the corporation's profitability and possibly the value of their individual investments.<sup>129</sup> Yet, existing corporate statutes—traditionally, the area of state jurisdiction—are not drafted with a sovereign shareholder in mind and, therefore, fail to provide a workable solution.<sup>130</sup> Administrative law, which operates on an assumption that federal government agencies make rules and administer laws rather than act as direct stakeholders in private firms, is similarly unhelpful.<sup>131</sup>

To the extent that the SGS proposal vests potentially significant levels of control over corporate decisions in the hands of SGS directors, it similarly transcends the doctrinal boundaries of both corporate and administrative law. While filling this gap in the existing system of laws is not a part of the present project, it is nevertheless possible to articulate the basic approach to designing a working system of judicial review of SGS decisions.

As a general matter, the SGS statute has to balance two goals: (1) shielding the SGS Holder from lawsuits brought against it by private parties, and (2) giving private shareholders reasonable protection against excessive harm caused by the SGS Holder's actions. However, because protecting the SGS Holder from incapacitating litigation battles is a vital prerequisite for effective operation of the SGS regime, the statute should explicitly and unambiguously prioritize the first objective over the second one.<sup>132</sup>

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129. See Marcel Kahan & Edward B. Rock, *When the Government Is the Controlling Shareholder*, 89 TEX. L. REV. 1293 (2011); J.W. Verret, *Treasury Inc.: How the Bailout Reshapes Corporate Theory and Practice*, 27 YALE J. ON REG. 283 (2010); see also Barbara Black, *The U.S. as "Reluctant Shareholder": Government, Business and the Law*, 5 ENTREPRENEURIAL BUS. L.J. 561, 593 (2010); Lissa L. Broome, *Government Investment in Banks: Creeping Nationalization or Prudent, Temporary Aid?*, 4 FLA. INT'L U. L. REV. 409 (2009); Steven M. Davidoff & David Zaring, *Regulation by Deal: The Government's Response to the Financial Crisis*, 61 ADMIN. L. REV. 463 (2009).

130. For insightful discussions of the doctrinal and practical limitations of corporate law in dealing with a sovereign shareholder, see Steven M. Davidoff, *Uncomfortable Embrace: Federal Corporate Ownership in the Midst of the Financial Crisis*, 95 MINN. L. REV. 1733 (2011), Steven Davidoff Solomon & David Zaring, *After the Deal: Fannie, Freddie, and the Financial Crisis Aftermath*, 95 B.U. L. REV. 371 (2015), and Marcel Kahan & Edward Rock, *When the Government is the Controlling Shareholder: Implications for Delaware*, 35 DEL. J. CORP. L. 409 (2010).

131. See Solomon & Zaring, *supra* note 130.

132. Ordinarily, federal government instrumentalities are protected from private lawsuits by the doctrine of sovereign immunity. See *United States v. Sherwood*, 312 U.S. 584, 586 (1941) ("The United States, as sovereign, is immune from suit save as it consents to be sued . . ."). However, if the SGS Holder is set up as a federally chartered government corporation, it may not be entitled to assert sovereign immunity as an impenetrable shield against shareholder suits. See *supra* notes 110–111 and accompanying text. In any event, depriving shareholders of covered entities of all access to courts may be counterproductive and harm the regime's overall legitimacy. Finally, it may be difficult to claim full sovereign immunity in the context in which a federal instrumentality acts in the capacity of a market participant, rather than in its traditional regulatory capacity. See *United States v. Winstar Corp.*, 518 U.S. 839, 887–88 (1996). A full discussion of these complex and highly technical issues of legal

For example, the statute may give the holders of common stock in a covered entity the right to sue the SGS Holder for damages incurred by such holders as a direct result of the SGS Holder's actions. This right, however, should be subject to strict limitations. Thus, only holders of common stock above a specified statutory threshold (expressed as a percentage of the firm's total common stock outstanding at the time of filing the lawsuit), who were common stockholders of that same firm for a specified minimum period of time (e.g., one year of continuous ownership), would have standing to sue the SGS Holder under the statute. These conditions would eliminate strategic acquisitions by various arbitrageurs of token amounts of common stock in covered entities with a view to suing the government.

Furthermore, the SGS Holder would be held liable under the statute only for actions taken in bad faith, with a specific intent to cause the plaintiff direct harm that, at the time of the SGS action, was clearly foreseeable, highly probable, and sufficiently precisely quantifiable. The shareholder plaintiff must bear the initial burden of proving bad faith, specific intent, high probability of the quantifiable direct harm to the plaintiff known or susceptible to proof at the time of the SGS Holder's action, and all other elements required by the statute. Setting this kind of a high standard for the plaintiff will help to protect shareholders from egregious abuses of the SGS Holder's statutory powers, while at the same time preventing a potential onslaught of frivolous private lawsuits against the SGS Holder.

It is worth noting here that shareholder lawsuits against the SGS Holder are also likely to claim some form of an uncompensated governmental taking of their property in violation of the Takings Clause of the Fifth Amendment to the U.S. Constitution.<sup>133</sup> In essence, these shareholders would argue that, by taking effective control over key corporate decisions that affected the firm's ability to generate greater profits and thus increase shareholder value, the SGS Holder deprived the firm's shareholders of their property rights. Controlling shareholders could also assert the uncompensated taking of their so-called control premium, a concept familiar to scholars and practitioners of corporate law. Under the proposed statutory scheme, however, such claims would be unlikely to succeed, especially because they would be fundamentally analogous to

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doctrine and practice is beyond the scope of what is necessary at this point in the proposed thought experiment. The key for present purposes is that statutory assertion of full sovereign immunity on the part of the SGS Holder and its agents may not be a viable, or desirable, choice.

133. There is a large body of caselaw and academic analysis of the Takings Clause, discussion of which is beyond the scope of this Article. For a summary of the U.S. Supreme Court precedent, see ROBERT MELTZ, CONG. RESEARCH. SERV., 97-122, TAKINGS DECISIONS OF THE U.S. SUPREME COURT: A CHRONOLOGY (2015), <https://www.fas.org/sgp/crs/misc/97-122.pdf>.

“regulatory takings” claims. In general, it is difficult for private plaintiffs to prevail on regulatory takings claims because every regulatory action inherently diminishes the value of private property subject to it.<sup>134</sup> In the SGS context, the SGS Holder’s temporary assumption of corporate management rights is designed to curb systemically risky behavior of financial institutions that some shareholders would say could have generated extra profits for them. To the extent the SGS statute explicitly and clearly articulates its public policy objectives, it should preempt such arguments.

### *C. Dealing with the Fear Factor*

A discussion of the design and operative features of the SGS regime would be incomplete without addressing, briefly but explicitly, the single most important challenge this proposal is bound to face: potentially deep-seated resistance to this type of bold institutional experimentation.

Some of that resistance will inevitably represent a conscious—and consciously concealed—effort by those who benefit, directly or indirectly, from the current state of affairs to preserve the status quo and to prevent any reforms that threaten it. Because of the fundamentally self-interested character of their objections, these critics are not likely to engage in a substantive discussion on the merits of the proposal. Their fear is that the proposed scheme could actually work as intended.

On the other hand, some of the likely skepticism toward the concept of a special golden share regime may come from those who are genuinely interested in finding workable mechanisms of systemic risk prevention. These critics may raise questions about specific legal and administrative details insufficiently developed in the outlined proposal or may worry about its various unintended consequences.

Some of these questions and concerns may reflect the inherent difficulty of mentally reconciling the proposed shift in the paradigm of bank governance with some of the basic assumptions built into today’s corporate governance orthodoxy. One such familiar assumption is that allowing the government inside the boardroom would effectively amount to “nationalization” of private enterprise and imposition of “socialism,” which is fundamentally incompatible with America’s “free-market economy” and commitment to “capitalism.”<sup>135</sup> This starkly dichotomous view of the world is, of course, empirically false: the government is the crucial actor within the modern free-market economy; its actions fundamentally enable and

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134. See *Lucas v. S.C. Coastal Council*, 505 U.S. 1003 (1992); *Nollan v. Cal. Coastal Comm’n*, 483 U.S. 825 (1987); *Penn Cent. Transp. Co. v. City of New York*, 438 U.S. 104 (1978).

135. See *Templin*, *supra* note 110.

often constitute the very markets we call “private.”<sup>136</sup> In that sense, the proposed SGS regime is neither “socialist” nor “capitalist.” It is pragmatic and incremental: it seeks to improve the operation and efficiency of the hybrid public–private market economy we already have.

The best way to dispel the fear of change induced by the ossified ideological vocabulary is to look past rhetorical labels and to assess the proposed regime on its merits. As discussed above, the SGS mechanism is designed to introduce the necessary systemic corrective into an inherently entity-centric perspective of individual firms’ boards. It is meant to operate as a dynamic and flexible tool for preventing or minimizing collective economic harms from individual firms’ actions. A well-functioning SGS regime should guide, rather than commandeer, individual banks’ and SIFIs’ internal decision-making in a way that helps to smooth seemingly unavoidable boom-and-bust cycles in financial markets—and to avoid the need for the government to use its “manager of last resort” powers in practice.<sup>137</sup>

Understanding the SGS proposal in these functional, rather than ideological, terms should also help to alleviate some of the more specific potential concerns about its consequences for the economic viability of financial firms. For example, it may very well be that the covered entities’ cost of capital might rise significantly, as private investors would either refuse to buy their shares or buy them at a deep discount. To the extent this type of market reaction reflects the generalized fear of a de facto “nationalization,” discussed above, it is likely to be both temporary and susceptible to correction. To the extent it reflects the degree of internalization of systemic risk posed by individual financial institutions, however, this change in their cost of capital should be seen as an efficiency-enhancing market adjustment. Whether or not such correction proves fatal to the entire banking sector is a question that cannot be answered in the abstract, though it seems unlikely that things would ever get so bad.<sup>138</sup> Speculative predictions aside, there is a strong argument that making bank managers focus on safeguarding the stability of the financial

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136. For an in-depth analysis of the role of public instrumentalities in constituting and augmenting financial markets, see *Public Actors*, *supra* note 13, and *The Finance Franchise*, *supra* note 53. See also MARIANA MAZZUCATO, *THE ENTREPRENEURIAL STATE: DEBUNKING PUBLIC VS. PRIVATE SECTOR MYTHS* (PublicAffairs 2015); Fred Block, *Swimming Against the Current: The Rise of a Hidden Developmental State in the United States*, 36 *POL. & SOC’Y* 169 (2008).

137. See *supra* note 103 and accompanying text.

138. There is another, somewhat related, concern that triggering active SGS rights with respect to a single SIFI could lead to a massive creditor and investor “run” on that SIFI and potentially trigger a systemic financial crisis. Essentially the same issue was widely debated in connection with the regulatory attempts worldwide to mandate the issuance by banks of contingent debt claims susceptible to bail-in under certain conditions. See, e.g., Hilary J. Allen, *Cocos Can Drive Markets Cuckoo*, 16 *LEWIS & CLARK L. REV.* 125 (2012) (discussing the pros and cons of contingent convertible capital instruments as a systemic risk prevention tool).



system should, in fact, increase banks' and other financial institutions' long-term value to investors.<sup>139</sup>

This is not to suggest, of course, that the SGS scheme is guaranteed to work perfectly in practice. No such guarantees can ever be given. It would be unrealistic, however, to attempt to discuss in a single article all of the potential consequences—intended or unintended, positive or negative—of the proposed regime. A full understanding of such consequences is likely to emerge only in the process of further refining and implementing the broad conceptual framework elaborated above.

#### CONCLUSION

This Article outlined principal contours of a new, and very unconventional by today's standards, regime of bank governance, in which the task of representing the public interest on individual banks' boards of directors is performed by a special federal instrumentality, the SGS Holder. The proposal advanced here is more of a thought experiment than a legislative blueprint. Developing such a blueprint would require thinking through and resolving many complex legal, economic, and administrative issues that are bound to arise in connection with such a bold departure from the current norm. Moreover, there may not be sufficient political will to pursue decisive measures of this kind, at least in the near future. And the financial services industry will relentlessly lobby against any reform likely to reduce Wall Street's profits by restricting its ability to externalize risk. For all these depressingly familiar reasons, the proposed regime may be simply too difficult to implement in practice.

Yet, it would be short-sighted to reject or dismiss this thought experiment too quickly. The golden share regime may prove to be more plausible than the critics are willing to acknowledge. Our current perceptions of how impossibly difficult it would be to implement the proposed SGS scheme may be significantly exaggerated, in large part because that proposal represents such a radical departure from what we've been conditioned to view as the "normal" state of play. Shifting our collective attitudinal and conceptual framework to accommodate the basic concept of the public as a legitimate endogenous corporate actor, on the other hand, is bound to broaden the universe of potential legal and administrative solutions to problems that might have previously seemed intractable. From that perspective, operationalizing the golden share regime envisioned here may be just the right challenge for the truly creative and ambitious lawyers and lawmakers.

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139. For a discussion of the interplay between systemic stability and shareholder value, see Armour & Gordon, *supra* note 46.

For now, however, the task is to begin articulating the basic notion of a hybrid public–private bank governance regime as an option on the menu of potential reforms. Thinking along these unorthodox lines could hold the key to unlocking the full potential of corporate governance, more generally, as a tool of public interest. The alternative is clear: if our existing system of corporate governance is simply too rigidly programmed to prioritize and safeguard short-term economic interests of certain private parties, then we must stop pretending that it can offer meaningful long-term solutions to our most pressing public policy problems. We will then have to search for such solutions elsewhere.