

The Catholic University of America, Columbus School of Law  
**CUA Law Scholarship Repository**

---

Scholarly Articles and Other Contributions

Faculty Scholarship

---

1998

## Regulating Risk Not Function

Heidi Mandanis Schooner

*The Catholic University of America, Columbus School of Law*

Follow this and additional works at: <https://scholarship.law.edu/scholar>



Part of the [Administrative Law Commons](#), and the [Banking and Finance Law Commons](#)

---

### Recommended Citation

Heidi Mandanis Schooner, Regulating Risk Not Function, 66 U. CIN. L. REV. 441 (1998).

This Article is brought to you for free and open access by the Faculty Scholarship at CUA Law Scholarship Repository. It has been accepted for inclusion in Scholarly Articles and Other Contributions by an authorized administrator of CUA Law Scholarship Repository. For more information, please contact [edinger@law.edu](mailto:edinger@law.edu).

# REGULATING RISK NOT FUNCTION

*Heidi Mandanis Schooner\**

## INTRODUCTION

Since the 1920s, my ninety-two-year-old grandmother has invested her savings in bank<sup>1</sup> accounts. Over the last decade, she has decried the declining interest rates on her bank certificates of deposit (CDs), but has never changed her investment strategy. Since the 1950s, my mother has invested her savings in securities products, insurance products, and a significant portion in a bank account—despite very low interest rates—because “you might need cash in an emergency.” Today, my modest savings are invested in securities and insurance products. I keep a minimal balance in a bank account—just enough to pay the mortgage and other monthly bills. In an emergency, I would use my credit card.

This brief genealogy illustrates the disintermediation<sup>2</sup> that has plagued the banking industry for the last twenty years. In 1995, aggregate mutual fund holdings surpassed bank deposits for the first time in history. In June of 1996, insured commercial bank deposits stood at \$2.6 trillion, while assets held in mutual funds totaled \$3.2 trillion.<sup>3</sup> Americans have become more sophisticated investors, more willing to take risk, or simply unwilling to accept meager returns on bank deposits.<sup>4</sup> Rather than succumbing to obsolescence, banks have responded by venturing beyond the traditional bank deposit to providing their customers with securities and insurance products.<sup>5</sup>

---

\* Associate Professor of Law, Columbus School of Law, The Catholic University of America. I would like to thank Bert Ely, Ely & Co.; Michael Taylor, Reading University; Patrick McCarty, FDIC; Donald Lamson, OCC; Sarah Miller, ABA; and Lawrence Pierce, FDIC, for their time and assistance in gathering sources for this Article. Special thanks to Steven Schooner and Robert Rosenblum for their cheerful willingness to read drafts and debate issues. I am grateful to Stephanie Leger for her energetic research assistance. The views expressed in this Article are my own and do not represent those of any of the above-listed individuals, agencies, or institutions.

1. The term “bank” is used to refer only to commercial banks offering insured deposits and not to savings associations and credit unions.

2. The term “disintermediation” refers to the flow of money out of bank deposits and into other investments, such as mutual funds. See Gary W. Lorenz, *Electronic Stored Value Payment Systems, Market Position, and Regulatory Issues*, 46 AM. U. L. REV. 1177, 1195-97 (1997); ROBERT L. TORTORIELLO, GUIDE TO BANK UNDERWRITING, DEALING, AND BROKERAGE ACTIVITIES I-18 (1997). The term also refers to the elimination of financial intermediaries, such as banks or brokers, from financial transactions. See generally Thomas W. Cashel, *Financial Services: Security, Privacy, and Encryption*, 3 B.U.J. SCI. & TECH. L. 4 (1997).

3. GAO, *Mutual Funds: SEC Adjusted Its Oversight in Response to Rapid Industry Growth*, GAO/GGD-97-67, at 3 (May 1997).

4. In 1989, 19% of U.S. families held bank certificates of deposit (CDs) and 7% owned mutual funds. By 1992, 17% of families held CDs and 11% owned mutual funds. See TORTORIELLO, *supra* note 2.

5. For a comprehensive discussion of banks’ securities activities, see TORTORIELLO, *supra* note 2. For a comprehensive discussion of national banks’ insurance activities, see *Guidance to National Banks on*

Federal banking laws, however, restrict banks' ability to venture far beyond traditional banking business.<sup>6</sup> With respect to securities activities, legislation from the 1930s restricts significantly a bank's ability to engage in the securities business.<sup>7</sup> Consensus opinion suggests, however, that banks must be given the opportunity to expand beyond their traditional activities to compete with the non-bank financial firms that continue to erode their customer base. Recently, banking regulators have taken bold steps to increase banks' securities powers.<sup>8</sup> Today, Congress is considering legislation that would allow further bank infiltration into the securities markets.<sup>9</sup>

The modernization of the business of banking will impact dramatically the fundamental structure of bank regulation.<sup>10</sup> Recognizing this, proposals for reform of restrictions on banks' securities activities have also addressed the need for structural change. Current reform proposals focus on a functional model of regulation, i.e., a model in which the scope of regulation is determined by function or product.<sup>11</sup> Put simply, the functional model provides that securities products should be regulated by the Securities and Exchange Commission (SEC) under federal securities laws<sup>12</sup> and banking products should be regulated by the federal bank regulators<sup>13</sup> under federal banking laws.<sup>14</sup> The functional model is contrasted with the institutional or entity model, which divides regulation according to institution or entity. The institutional model provides that banks should be regulated under the banking laws by bank regulators and securities firms should be regulated under the securities

---

*Insurance and Annuity Sales Activities*, 1996 OCC CB LEXIS 101, AL 96-8 (Oct. 8, 1996); Troy Cichos, *Small Towns, Large Stakes: New Battles Over Bank Insurance Sales Under the National Bank Act*, 43 DRAKE L. REV. 651 (1995).

6. See generally Julie L. Williams & Mark P. Jacobsen, *The Business of Banking: Looking to the Future*, 50 BUS. LAW. 783 (1995) (discussing generally restrictions on national banks' activities).

7. See Part I (discussing restrictions on banks' securities activities).

8. See *infra* notes 26-38 and accompanying text.

9. See *infra* note 199.

10. The term "regulation" is used, unless otherwise indicated, to refer generically to agencies' rulemaking authority, supervisory authority (i.e., their ability to monitor and examine banks' practices and operations), and enforcement authority (i.e., their ability to bring civil, criminal, or administrative proceedings to enforce laws).

11. See *infra* Part III for a discussion of the functional regulation model.

12. The term "federal securities laws" is used to refer to the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940. These statutes are discussed in detail in Part II of this Article.

13. The terms "federal bank regulators" or "federal bank agencies" are used to refer to the Board of Governors for the Federal Reserve System (Fed), the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC), unless otherwise indicated.

14. The term "federal banking laws" is used to refer to the National Bank Act, the Bank Holding Company Act, and the Federal Deposit Insurance Act, as each of those laws have been amended from time to time.

laws by the SEC. Our current system operates substantially on a functional basis. To the extent that current legislative proposals for reform rely on the functional model, they do not provide for much change from the status quo.

The twenty-first century will demand real change rather than adjustments to an antiquated regulatory regime. The functional regulatory model will not prove effective in the consolidated, international, and technologically-advanced financial markets of the future. This Article contends that a more appropriate model for the future should be risk based, focusing on the risks that we seek to regulate through the laws affecting finance. Under a risk based model, the breadth of laws and the division of regulatory responsibility is determined by the risk to be regulated, i.e., bank insurance fund risk, systemic risk, and risk of unfairness. A risk based model, because it does not depend on product or entity definitions, can abide the development of new products through technological advances and other market innovations, and the changes in the character of financial institutions through consolidation. Moreover, because the risk based model focuses directly on the purpose of financial regulation, it proves more effective and efficient than the current system.

This Article examines our current scheme of bank regulation through an analysis of banks' securities activities<sup>15</sup>—how such activities are currently regulated and how they might be regulated in the future. Part I summarizes the major restrictions on banks' securities activities, emphasizing recent regulatory initiatives aimed toward expanding banks' participation in the securities business. Part II examines the application of the federal securities laws to banks' securities activities. (While banks enjoy some exemptions from the federal securities laws, they are subject to many of the most important provisions.) In addition, Part II sets forth the division of responsibility for administering the securities laws among the federal banking regulators and the SEC.

Part III analyzes the current paradigm of regulation of banks' securities activities and concludes that the current model combines elements of functional and institutional regulation in form. Yet, once actual bank securities activities are taken into consideration, the current model more closely resembles functional regulation and, therefore, can be designated "the functional equivalent to functional regulation." Part IV evaluates the current model of regulation of banks' securities

---

15. The term "banks' securities activities" is used broadly to refer to activities relating to a bank's own stock and a bank's involvement in the securities business. Unless otherwise indicated, the term refers to activities that take place within the bank itself, within a bank subsidiary, or a bank affiliate. This Article does not attempt to address similar issues relating to banks' expansion into insurance activities.

activities using the conventional understanding of the goals of the federal banking laws and the federal securities laws. This Part concludes that, given the current dimensions of actual bank securities activities, the incumbent model provides an acceptable compromise between the benefits of the functional model and those of the institutional model. Part V considers the durability of our current system of regulation and proposals for reform which seek only to provide more pure functional regulation. Part V concludes that the current model will not endure in an era of expanded bank securities activities and financial market consolidation. Part V contends that a system of regulation which is divided by risk is better suited to the financial markets of the future.

### I. RESTRICTIONS ON BANKS' SECURITIES ACTIVITIES: GLASS-STEAGALL

In 1933, Congress enacted the Glass-Steagall Act (Glass-Steagall)<sup>16</sup> for the purpose of "ensuring the stability of banks and protecting bank depositors."<sup>17</sup> To this day, Glass-Steagall contains the major restrictions<sup>18</sup> on banks' securities activities. Section 16 of Glass-Steagall provides:

The business of dealing in securities and stock by [national banks] shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and [national banks] shall not underwrite any issue of securities or stock: Provided, That [a national bank] may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe.<sup>19</sup>

---

16. Banking Act of 1933, ch. 89, 48 Stat. 162 (codified at 12 U.S.C. § 227 (1996)).

17. *Securities Indus. Ass'n v. Clarke*, 885 F.2d 1034, 1051-52 (2d Cir. 1989). The purpose is not investor protection, which is the focus of the federal securities laws. *See id.* Moreover, the goal of the legislation was not simply to limit a bank's ability to make risky investments. The Supreme Court has identified certain "subtle hazards" that the Glass-Steagall Act (Glass-Steagall) was intended to address. *Investment Co. Inst. v. Camp*, 401 U.S. 617 (1971). For example, the legislation was intended to preserve the public's confidence in banks and banks' "ability to function as an impartial source of credit." *Id.* at 631.

18. Other provisions of the banking laws could also limit banks' securities activities; one example is the banking laws' general prohibition on unsafe or unsound banking practices. *See* 12 U.S.C. § 1818(b) (1996). Because of the comprehensive nature of Glass-Steagall, other sources of limitations of bank securities activities are not generally the focus of attention or discussion.

19. *Id.* § 24 (seventh). The § 16 restrictions are also applicable to state member banks. *See id.* § 335. Section 16 does not apply to state nonmember banks. Section 21 of Glass-Steagall, however, is applicable to state nonmember banks, *see infra* notes 2-4 and accompanying text, providing many of the same restrictions. Section 21, however, does not restrict banks' investments in securities. Therefore, until the passage of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), state nonmember banks had more flexibility in their securities investments. FDICIA imposed on state nonmember banks the same investment limitations as are applicable to national banks. *See id.* § 1831a.

Section 16 prohibits a national bank from most underwriting. Nonetheless, by permitting the purchase or sale of securities "solely upon the order, and for the account of, customers," § 16 allows banks to engage in securities brokerage.<sup>20</sup> In addition, underwriting, purchases, and sales of "investment securities" are permitted.<sup>21</sup> Investment securities include certain federal, state, and municipal government securities.<sup>22</sup>

Glass-Steagall not only restricts the activities of banks, but separates the business of commercial banking from investment banking.<sup>23</sup> Section 21 of Glass-Steagall prohibits any firm "engaged in the business of issuing, underwriting, selling, or distributing" securities from also engaging in the deposit-taking business.<sup>24</sup> The Glass-Steagall separation of commercial and investment banking is not drawn along corporate entity lines. Section 20 of Glass-Steagall prohibits member banks (i.e., national banks and state member banks) from affiliating with any firm "engaged principally in the issue, flotation, underwriting, public sale, or distribution" of securities.<sup>25</sup> Progressive interpretation of § 20 has been the source of much of the recent growth of banks' securities activities.

In 1987, the Board of Governors for the Federal Reserve System (Fed) approved an application by Citicorp, J.P. Morgan, and Bankers Trust to create a non-bank subsidiary—commonly referred to as a "§ 20 subsidiary"—of a bank holding company that would be permitted to underwrite commercial paper, municipal revenue bonds, and mortgage backed securities.<sup>26</sup> The Fed's approval was based on an interpretation of the "engaged principally" language found in § 20. The Fed determined that the § 20 subsidiary would not be engaged principally in underwriting securities if the underwriting of bank-ineligible securities was limited to five percent of the subsidiaries' gross revenues, and the activities with regard to bank ineligible securities did not constitute more than five percent of the market for any type of security. In addition, the

---

20. See *Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.*, 468 U.S. 207 (1984) (discount brokerage permissible); *Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.*, 821 F.2d 810 (D.C. Cir. 1987) (full service brokerage permissible).

21. See 12 C.F.R. § 1 (1997) (investment securities regulation).

22. See *id.* The securities that a national bank can underwrite, purchase, or sell pursuant to § 16 of Glass-Steagall are often referred to as "bank-eligible" securities.

23. See *Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.*, 468 U.S. 137, 147-48 (1984); *Board of Governors of the Fed. Reserve Sys. v. Investment Co. Inst.*, 450 U.S. 46, 70 (1981).

24. 12 U.S.C. § 378. This provision applies to all banks (i.e., national banks, state member banks, and state nonmember banks) and securities firms.

25. *Id.* § 377. In addition, § 32 of Glass-Steagall prohibits certain management interlocks between member banks and firms "primarily engaged in the issue, flotation, underwriting, public sale, or distribution" of securities. *Id.* § 78.

26. See 73 Fed. Res. Bull. 473 (1987).

Fed imposed certain "firewalls" to address safety and soundness issues and potential conflicts of interest.<sup>27</sup> The Second Circuit upheld the Fed's interpretation but eliminated the market share limitation.<sup>28</sup>

In the years since the first approval, the Fed has incrementally liberalized its interpretation of permissible activities for § 20 subsidiaries. In 1989, the Fed approved the underwriting of debt and equity securities for § 20 subsidiaries.<sup>29</sup> The Fed increased the revenue limitation, first from five to ten percent,<sup>30</sup> and then, in 1996, from ten to twenty-five percent.<sup>31</sup> In 1997, the Fed eliminated most of the firewalls originally imposed on § 20 subsidiary activities.<sup>32</sup>

Not to be outdone by the Fed, the Office of the Comptroller of the Currency (OCC) recently adopted a controversial rule governing the activities of operating subsidiaries of national banks (commonly known as the "op-sub rule").<sup>33</sup> Most importantly, the op-sub rule provides that a national bank may, assuming compliance with certain procedures and safeguards, acquire or establish a subsidiary that would engage in activities which would not be permissible for the bank itself.<sup>34</sup>

The Fed's liberalization of its regulations governing § 20 subsidiaries of bank holding companies and the OCC's op-sub rule achieve a manner of regulatory modernization of the banking industry beyond even recent imagination. The industry reacted swiftly to take advantage of these new opportunities. In April of 1997, Banker's Trust New York Corp. announced that it was purchasing Alex. Brown & Sons Inc.,<sup>35</sup> and

---

27. The "firewalls" were imposed not under Glass-Steagall, but under § 4(c)(8) of the Bank Holding Company Act which restricts bank holding company activities and investments to those that are "so closely related to banking." 12 U.S.C. § 1843(c)(8) (1996). For a detailed description of the Fed's firewalls, see TORTORIELLO, *supra* note 2, at Appendix B.

28. See *Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.*, 839 F.2d 47 (2d Cir. 1988).

29. See 75 Fed. Res. Bull. 192 (1989).

30. See 75 Fed. Res. Bull. 771 (1989).

31. See 61 Fed. Reg. 68,750 (1996).

32. See 62 Fed. Reg. 45,295 (1997) (to be codified at 12 C.F.R. pt. 225).

33. See 61 Fed. Reg. 60,342 (1996) (to be codified at 12 C.F.R. pts. 3, 5, 7, 16, and 28). For a discussion of industry reaction to the rule, see Alfred J.T. Bryne, *Financial Modernization: Maybe Congress Will Just Let It Happen*, AM. BANKER, May 16, 1997, at 3; William Isaac, *OCC Rule on Subsidiaries Is Sound Public Policy*, AM. BANKER, Dec. 19, 1996, at 5; Bert Ely, *New OCC Rule May Trigger a Wave of Sweeping Changes*, AM. BANKER, Dec. 11, 1996, at 4. No doubt anticipating legal debate over the rule, the OCC published a memorandum outlining the Comptroller's legal authority to adopt the rule. See Memorandum from Julie L. Williams, Chief Counsel, to Eugene A. Ludwig, Comptroller of the Currency (Nov. 18, 1996) (CCH Federal Banking Law Reports ¶ 90-464).

34. See 12 C.F.R. § 5.34(f) (1997). The rule provides for notice and comment when the activity has not before been approved by the OCC. See *id.* § 5.34(f)(1). The subsidiary must comply with certain corporate separateness requirements, see *id.* § 5.34(f)(2), and supervisory requirements, see *id.* § 5.34(f)(3).

35. See Niamh Ring, *Wedding Announcement for Bankers Trust and Alex. Brown Pleases the Street*, THE BOND BUYER, Apr. 8, 1997, at 5.

on July 21, 1997, the Fed announced approval of the transaction.<sup>36</sup> Other bank holding companies quickly followed suit.<sup>37</sup>

The OCC's op-sub is also likely to spur important changes in the banking and securities industries. It is widely believed that the rule will enable national banks, among other things, to engage in expanded securities activities through their own subsidiaries rather than having to rely on the bank holding-company affiliate approach (and, Fed supervision). The OCC approved recently an application by a national bank for an operating subsidiary to engage in underwriting and dealing in securities of states and their political subdivisions.<sup>38</sup>

## II. APPLICATION OF THE SECURITIES LAWS TO BANKS' SECURITIES ACTIVITIES

Subject to Glass-Steagall restrictions, banks engage in various activities involving securities. Because banks are subject to a comprehensive regulatory regime,<sup>39</sup> banks are exempt from some important provisions of the securities laws. On the other hand, many key provisions of the securities laws apply to banks. Moreover, the exemptions enjoyed by banks are not generally extended to bank holding companies or non-bank subsidiaries or affiliates of banks. Therefore, the application of the federal securities laws will depend on whether the securities activity is conducted by the bank itself as opposed to a bank subsidiary, non-bank affiliate of a bank, or bank holding company.

### A. Regulation of the Security

Congress has passed various laws that regulate transactions involving securities—from the original issuance of the security to purchases and

---

36. See *In re Bankers Trust New York Corporation*, New York, New York, Order Approving Notice to Engage in Nonbanking Activities, Federal Reserve Press Release (July 21, 1997).

37. On May 15, 1997, Swiss Bank Corp. announced its acquisition of Dillon, Read & Co. See Niamh Ring, *Swiss Bank to Acquire Dillon Read; Fate of Municipal Division Is Unclear*, THE BOND BUYER, May 16, 1997, at 1. On July 28, 1997, the Fed approved this acquisition. See *In re Swiss Bank Corporation*, Basel, Switzerland, Order Approving Notice to Engage in Nonbanking Activities, Federal Reserve Press Release (July 28, 1997). On June 30, 1997, NationsBank Corp. announced its acquisition of Montgomery Securities. See Jill Dutt, *NationsBank to Buy Brokerage*, THE WASHINGTON POST, July 1, 1997, at C2. On September 10, 1997, the Fed approved this acquisition. See *In re NationsBank Corp.*, Order Approving Notice to Engage in Certain Nonbanking Activities, Federal Reserve Press Release (Sept. 10, 1997).

38. See Decision of the Comptroller of the Currency on the Application by Zions First National Bank, Salt Lake City, Utah to Commence New Activities in an Operating Subsidiary, 1997 OCC Ltr. LEXIS 127 (Dec. 11, 1997).

39. See *American Bankers Ass'n v. SEC*, 804 F.2d 739, 746 (D.C. Cir. 1986).



sales of the security on the secondary market. In general, these laws require registration of securities and disclosure relating to transactions involving the security and also prohibit fraud in connection with transactions in the security. For non-bank issuers of securities, the SEC is the primary regulator charged with administering these laws. Bank issuers of securities are exempt from some of the federal securities laws relating to transactions involving their securities. When the laws apply to banks, the regulatory authority to administer the laws is divided between the SEC and the "appropriate federal banking regulator."<sup>40</sup>

The definition of "security" in the Securities Act of 1933 (the Securities Act) excludes "any security issued or guaranteed by any bank."<sup>41</sup> Therefore, banks need not comply with the registration requirements of § 5 of the Securities Act.<sup>42</sup> Moreover, banks cannot be held liable under § 12 of the Securities Act for violation of § 5 registration requirements, or for making a material misrepresentation or omission in a prospectus or oral communication.<sup>43</sup> Importantly, the exemption for bank-issued stock does not apply to bank holding companies.<sup>44</sup> The federal banking agencies have adopted disclosure requirements in connection with the purchase or sale of securities of a bank.<sup>45</sup> These disclosure requirements, however, are not adopted under the authority of the securities laws, but, rather, the federal banking statutes.<sup>46</sup>

The provisions of § 12 of the Securities and Exchange Act of 1934 (Exchange Act),<sup>47</sup> relating to the registration of securities traded on a national securities exchange, apply to securities issued by banks. The federal banking regulators, however, not the SEC, are responsible for

40. In this Part, the term "appropriate federal banking regulator" is used to refer to the OCC with respect to the regulation of national banks; the Fed for state member banks; the FDIC for state non-member banks; and the Office of Thrift Supervision (OTS) for savings associations.

41. Securities Act of 1933 § 3(a)(2), 15 U.S.C. § 77c(a)(2) (1997). The term "bank" under the Securities Act means "any national bank, or any banking institution organized under the laws of any State, territory, or the District of Columbia, the business of which is substantially confined to banking and is supervised by the State or territorial banking commission or similar official." *Id.*

42. *See* Securities Act of 1933 § 5, 15 U.S.C. § 77d (1997).

43. *See id.* § 12, 15 U.S.C. § 77i.

44. *See* Bankers Trust Co., [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,474 (Oct. 22, 1971).

45. *See* 12 C.F.R. §§ 16 (OCC), 303.15 (FDIC), 563.76 (OTS) (1997).

46. The OCC cites the provision creating the Office of the Comptroller, 12 U.S.C. § 1, and its general rulemaking authority, 12 U.S.C. § 93a, as authority for the disclosure requirements provided in part 16 of its rules. *See* 12 C.F.R. § 16.1(a) (1997). The OTS cites various banking statutes as authority for its regulation of offers and sales of association securities. *See id.* § 563. The FDIC relies on various banking statutes as authority for its regulation requiring disclosure of mutual-to-stock conversions. *See id.* § 303.

47. June 6, 1934, ch 404, Title I, § 1, 48 Stat. 881.

the administration of § 12 against banks.<sup>48</sup> The same is true for §§ 13 (reporting requirements for issuers of securities registered on a national securities exchange), 14(a) and (c) (regulation of proxy solicitations), 14(d) and (f) (regulation of tender offers), and 16 (regulation of short swing insider profits) of the Exchange Act, i.e., the federal banking regulators are responsible for the administration of those provisions against banks.<sup>49</sup> Congress directed the federal banking regulators to “issue substantially similar regulations to regulations and rules issued by the [SEC] under [these sections] unless they find that implementation of substantially similar regulations with respect to insured banks and insured institutions are not necessary or appropriate in the public interest or for protection of investors . . . .”<sup>50</sup> The federal banking agencies have adopted the SEC’s rules, regulations, and forms,<sup>51</sup> or substantially similar ones.<sup>52</sup>

Perhaps most significantly, banks are subject to the antifraud provisions of § 17 of the Securities Act<sup>53</sup> and § 10(b) of the Exchange Act.<sup>54</sup> The SEC has the authority to enforce violations of these laws.<sup>55</sup>

### B. Regulation of Securities Business

Congress also passed various laws regulating participants in the securities business, for example, brokers, dealers, investment companies, and investment advisers. In some instances, banks are exempt from

---

48. Securities Exchange Act of 1934 § 12(i), 15 U.S.C. § 78l(i) (1997). The OCC has responsibility for national banks and banks operating under the law of the District of Columbia. The Fed has responsibility with regard to all other banks that are members of the Federal Reserve, i.e., state member banks. The FDIC has responsibility for all other FDIC-insured banks, i.e., state nonmember banks. The OTS has responsibility for all FDIC-insured savings associations. *See id.* For an in-depth discussion of § 12(i) and an argument in favor of its repeal, see Michael P. Malloy, *The 12(i)'ed Monster: Administration of the Securities Exchange Act of 1934 by the Federal Bank Regulatory Agencies*, 19 HOFSTRA L. REV. 269 (1990).

49. *See* Securities Exchange Act of 1934 § 12(i), 15 U.S.C. § 78l(i) (1997).

50. *Id.*

51. *See* 12 C.F.R. §§ 11.2 (OCC), 208.16(a) (Federal Reserve System), 563d (OTS) (1997).

52. *See id.* § 335 (FDIC).

53. 15 U.S.C. § 77q. This is because § 17 applies broadly to any “person.” The term “person” under the Securities Act means “an individual, a corporation, a partnership, an association, a joint-stock company, a trust, any unincorporated organization, or a government or political subdivision thereof.” Securities Act of 1933 § 2(2), 15 U.S.C. § 77b(a)(2) (1997).

54. 15 U.S.C. § 78j(b). This is because § 10(b) applies broadly to any “person.” The term “person” under the Exchange Act means “a natural person, company, government, or political subdivision, agency, or instrumentality of a government.” Securities Exchange Act of 1934 § 3(a)(9), 15 U.S.C. § 78c(a)(9) (1997).

55. *See infra* Part II.C (discussing the SEC enforcement authority). The Supreme Court has held that, although the SEC must prove scienter in actions brought to enjoin violations of § 17(a)(1) of the Securities Act and § 10(b) of the Exchange Act and Rule 10b-5, the SEC need not prove scienter under §§ 17(a)(2) or 17(a)(3). *See* Aaron v. SEC, 446 U.S. 680, 687-700 (1980).

these laws. As with the laws relating to transactions in banks' securities,<sup>56</sup> when the laws regulating the securities business apply to banks, the regulatory authority to implement and enforce the laws is divided and sometimes shared between the SEC and the federal banking regulators.

The Exchange Act exempts banks<sup>57</sup> from the definitions of "broker"<sup>58</sup> and "dealer."<sup>59</sup> This excludes banks from the broker-dealer registration, supervision, and regulation under the Exchange Act.<sup>60</sup> Only the bank itself is privy to these exemptions. Thus, if a bank holding company, a bank subsidiary, or a non-bank affiliate of a bank engages in broker-dealer activities, such entities would be subject to Exchange Act regulation.<sup>61</sup> In addition, foreign banks that engage in securities business with individuals or companies located in the United States are not exempt from broker-dealer registration unless they meet certain regulatory requirements.<sup>62</sup>

Section 15B of the Exchange Act<sup>63</sup> encompassed the federal regulation of municipal securities<sup>64</sup> brokers and dealers. Banks are not

56. *See supra* Part II.A.

57. The Exchange Act defines "bank" as:

(A) a banking institution organized under the laws of the United States, (B) a member bank of the Federal Reserve System, (C) any other banking institution, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks . . . , and which is supervised and examined by State or Federal authority having supervision over banks, and which is not operated for the purpose of evading the provisions of this chapter, and (D) a receiver, conservator, or other liquidating agent of any institution or firm included in clauses (A), (B), or (C) of this paragraph.

Securities Exchange Act of 1934 § 3(a)(6), 15 U.S.C. § 78c(a)(6) (1997).

58. Securities Exchange Act of 1934 § 3(a)(4), 15 U.S.C. § 78c(a)(4) (1997).

59. *Id.* § 3(a)(5), 15 U.S.C. § 78c(a)(5).

60. *See id.* § 15, 15 U.S.C. § 78o. The Exchange Act, however, does not exempt banks from its general antifraud provisions. *See supra* note 54 and accompanying text. In 1985, the SEC promulgated Rule 3b-9, which sought to bring banks acting as brokers or dealers within the SEC's regulatory authority. The District of Columbia Court of Appeals invalidated Rule 3b-9, holding that the rule exceeded the SEC's authority under the Exchange Act. *See American Bankers Ass'n v. SEC*, 804 F.2d 739 (D.C. Cir. 1986).

61. In addition, the definition of "bank" under the Exchange Act has been interpreted to exclude savings associations, *see* St. Paul Federal Bank for Savings, SEC No-Action Letter, 1988 SEC No-Act LEXIS 1410 (Oct. 13, 1988), and credit unions, *see* DAVID A. LIPTON, BROKER-DEALER REGULATION, § 1.10[3][e] (Securities Law Series, Vol. 15). Therefore, to the extent that such institutions engage in broker or dealer activities, they are regulated by the SEC.

62. *See generally* MELANIE L. FEIN, SECURITIES ACTIVITIES OF BANKS § 10.03[B] (1997).

63. June 6, 1934, ch 404, Title I, § 15B, as added June 4, 1975, P.L. 94-29, § 13, 89 Stat. 131; June 6, 1983, P.L. 98-38, § 4, 97 Stat. 207.

64. The term "municipal securities" means:

[S]ecurities which are direct obligations of, or obligations guaranteed as to principal or interest by, a State or any political subdivision thereof, or any agency or instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality of

excluded from the definition of “municipal securities dealer”<sup>65</sup> and, therefore, are required to register with the SEC and are subject to SEC regulation and supervision.<sup>66</sup> A bank acting as a municipal securities dealer must comply with the rules of the Municipal Securities Rulemaking Board (MSRB).<sup>67</sup> Banks are also not excluded from the definition of “municipal securities broker”<sup>68</sup> and are subject to the rules and regulations of the MSRB that apply to municipal securities brokers.<sup>69</sup> Section 15B authorizes both the SEC and the appropriate federal banking regulator to bring enforcement actions under that title against banks acting as municipal securities dealers.<sup>70</sup>

Section 15C of the Exchange Act encompassed the federal regulation of government securities<sup>71</sup> brokers and dealers. While banks are included within the definitions of “government securities broker”<sup>72</sup> and

one or more States, or any security which is an industrial development bond . . . .  
Securities Exchange Act of 1934 § 3(a)(39), 15 U.S.C. § 78c(a)(29).

65. *Id.* § 3(a)(30), 15 U.S.C. § 78c(a)(30). A bank is excluded from the definition of “municipal securities dealer” if it does not buy or sell municipal securities for its own account as a part of its regular business or if it buys or sells municipal securities in a fiduciary capacity. *Id.* The Exchange Act defines a “municipal securities dealer” as:

[A]ny person (including a separately identifiable department or division of a bank) engaged in the business of buying and selling municipal securities for his own account, through a broker or otherwise, but does not include . . . (B) a bank, unless the bank is engaged in the business of buying and selling municipal securities for its own account other than in a fiduciary capacity, through a broker or otherwise: *Provided, however,* That if the bank is engaged in such business through a separately identifiable department or division . . . , the department or division and not the bank itself shall be deemed to be the municipal securities dealer.

*Id.*

66. *See id.* § 15B, 15 U.S.C. § 78o-4. For a discussion of the regulation of banks acting as municipal securities dealers, see David A. Lipton, *Broker-Dealer Regulation*, (Securities Law Series, Volume 15) § 1.11[1].

67. *See* Securities Exchange Act of 1934 § 15B(b), 15 U.S.C. § 78o-4(b). Congress directed the SEC to establish the Municipal Securities Rulemaking Board (MSRB) and directed the MSRB to “propose and adopt rules to effect the purposes of this chapter with respect to transactions in municipal securities effected by brokers, dealers, and municipal securities dealers.” 15 U.S.C. § 78o-4(b)(2) (1997).

68. The Exchange Act defines “municipal securities broker” as “a broker engaged in the business of effecting transactions in municipal securities for the account of others.” Section 3(a)(31) of the Exchange Act; 15 U.S.C. § 78c(a)(31).

69. *See* Securities Exchange Act of 1934 § 15B(b), 15 U.S.C. § 78o-4(b).

70. *See id.* § 15B(c), 15 U.S.C. § 78o-4(c).

71. Government securities are “securities issued or guaranteed by the U.S. government and its agencies and instrumentalities . . . [and] include U.S. Treasury securities and securities issued by government agencies and government sponsored enterprises such as the Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, the Federal Home Loan Banks, and similar entities.” FEIN, *supra* note 62, § 10.03[B], n.92. The Exchange Act definition is found at 15 U.S.C. § 78c(42).

72. The Exchange Act defines “government securities broker” as “any person regularly engaged in the business of effecting transactions in government securities for the account of others . . . .” Securities Exchange Act of 1934 § 3(a)(44), 15 U.S.C. § 78c(a)(43).

“government securities dealer,”<sup>73</sup> they need not register with the SEC as do non-bank government securities brokers or dealers.<sup>74</sup> Instead, a bank acting as a government securities broker or dealer must file written notice with the appropriate federal banking regulator.<sup>75</sup> The appropriate federal banking regulator, not the SEC, has the authority under § 15C to investigate or take other enforcement action against a bank.<sup>76</sup>

Congress established a national system for clearance and settlement of securities transactions under § 17A of the Exchange Act.<sup>77</sup> Section 17A regulates “clearing agencies” which are firms that act as intermediaries in the settlement of securities transactions.<sup>78</sup> In general, clearing agencies must register with the SEC. Banks, savings associations, brokers and dealers, however, are exempt from registration if they are engaged in clearing activities “solely by reason of functions performed by such institution as part of customary banking, brokerage, [or] dealing . . . , or solely by reason of acting on behalf of a clearing agency . . . in connection with the . . . services of the clearing agency . . . .”<sup>79</sup> Banks that are registered with the SEC as clearing agencies are supervised by their appropriate federal banking regulator.<sup>80</sup> The SEC, however, retains its own enforcement and rulemaking authority.<sup>81</sup>

73. *Id.* § 3(a)(44), 15 U.S.C. § 78c(a)(44). A bank is excluded from the definition of “government securities dealer” if it does not buy or sell government securities for its own account as a part of its regular business or if it buys or sells government securities in a fiduciary capacity. *See id.* The Exchange Act defines “government securities dealer” as:

[A]ny person engaged in the business of buying and selling government securities for his own account, through a broker or otherwise, but does not include . . . (C) any bank, unless the bank is engaged in the business of buying and selling government securities for its own account other than in a fiduciary capacity, through a broker or otherwise . . . .

*Id.*

74. *See id.* § 15C(a)(1)(A), 15 U.S.C. § 78o-5(a)(1)(A).

75. *See id.* § 15C(a)(1)(B), 15 U.S.C. § 78o-5(a)(1)(B). *Id.* § 3(a)(34)(G), 15 U.S.C. § 78c(a)(34)(G).

76. *See id.* § 15B(g)(2), 15 U.S.C. § 78o-5(g)(2).

77. June 6, 1934, ch 404, Title I, § 17A, as added June 4, 1975, P.L. 94-29, § 15, 89 Stat. 141. Congress found that “[t]he prompt and accurate clearance and settlement of securities transactions, including the transfer of record ownership and the safeguarding of securities and funds related thereto, are necessary for the protection of investors and persons facilitating transactions by and acting on behalf of investors.” Securities Exchange Act of 1934 § 17A(a)(1), 15 U.S.C. 78q-1(a)(1).

78. Section 3(a)(23)(A) of the Exchange Act defines a “clearing agency” as:

[A]ny person who acts as an intermediary in making payments or deliveries or both in connection with transactions in securities or who provides facilities for comparison of data respecting the terms of settlement of securities transactions, to reduce the number of settlements of securities transactions, or for the allocation of securities settlement responsibilities.

15 U.S.C. § 78c(a)(23)(A).

79. *Id.* § 3(a)(23)(B), 15 U.S.C. § 78c(a)(23)(B).

80. *See id.* § 3(a)(34)(B), 15 U.S.C. § 78c(a)(34)(B); § 17A(d), 15 U.S.C. § 78q-1(d).

81. *See id.* § 17A(d)(3)(B), 15 U.S.C. § 78q-1(d)(3)(B).

Section 17A also provides for the registration and supervision of transfer agents.<sup>82</sup> Transfer agents perform certain functions that affect the transfer of ownership of securities.<sup>83</sup> Banks are not exempt from the definition of “transfer agent” and, accordingly, must register with their appropriate federal banking agency if they engage in transfer agent activities.<sup>84</sup> The appropriate federal banking regulators have the primary responsibility to supervise and enforce § 17A as against banks.<sup>85</sup> The SEC retains backup rulemaking and enforcement authority.<sup>86</sup>

The Investment Company Act of 1940 (ICA) excludes banks<sup>87</sup> from the definition of investment company.<sup>88</sup> Bank holding companies are also excluded from the definition.<sup>89</sup> Banks, therefore, are excluded from the registration, supervision, and regulation of investment companies under the ICA.<sup>90</sup>

The Investment Advisers Act of 1940 (IAA) excludes banks<sup>91</sup> from the

82. *See id.* § 17A(c), 15 U.S.C. § 78q-1(c).

83. Section 3(a)(25) of the Exchange Act defines “transfer agent” as:

[A]ny person who engages on behalf of an issuer of securities or on behalf of itself as an issuer of securities in (A) countersigning such securities upon issuance; (B) monitoring the issuance of such securities with a view to preventing unauthorized issuance, a function commonly performed by a person called a registrar; (C) registering the transfer of such securities; (D) exchanging or converting such securities; or (E) transferring record ownership of securities by bookkeeping entry without physical issuance of securities certificates.

15 U.S.C. § 78c(a)(25).

84. *See* Securities Exchange Act of 1934 § 17A(c)(2), 15 U.S.C. § 78q-1(c)(2); § 3(a)(34)(B), 15 U.S.C. § 78c(a)(34)(B).

85. *See id.* § 17A(d), 15 U.S.C. § 78q-1(d).

86. *See id.* § 17A(d)(3)(B), 15 U.S.C. § 78q-1(d)(3)(B).

87. The term “bank” is defined under the Investment Company Act (ICA) similarly to the definition found in the Exchange Act. The term “bank” under the ICA means:

(A) a banking institution organized under the laws of the United States, (B) a member bank of the Federal Reserve System, (C) any other banking institution or trust company, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks . . . , and which is supervised and examined by State or Federal authority having supervision over banks, and which is not operated for the purpose of evading the provisions of this subchapter, and (D) a receiver, conservator, or other liquidating agent of any institution or firm included in clauses (A), (B), or (C) of this paragraph.

Investment Company Act of 1940 § 2(a)(5), 15 U.S.C. § 80a-2(a)(5) (1997).

88. *See id.* § 3(c)(3), 15 U.S.C. § 80a-3(c)(3). The exclusion also extends to insurance companies, savings and loan associations, *see id.*, and to brokers and dealers. *Id.* § 3(c)(2), 15 U.S.C. § 80a-3(c)(2).

89. *See id.* § 3(c)(6), 15 U.S.C. § 80a-3(c)(6).

90. *See id.* § 8, 15 U.S.C. § 80a-8. *See generally* ROBERT ROSENBLUM, INVESTMENT COMPANY DETERMINATION UNDER THE 1940 ACT: EXEMPTIONS AND EXCEPTIONS (1997).

91. “Bank” is defined under the Investment Advisers Act (IAA) similarly to the definition found in the Exchange Act and in the ICA, *see supra* notes 57 and 87. The term “bank” under the IAA means:

(A) banking institution organized under the laws of the United States, (B) a member bank of the Federal Reserve System, (C) any other banking institution or trust company, whether

definition of investment adviser.<sup>92</sup> In addition, the IAA goes one step further by excluding any “banking holding company as defined in the Bank Holding Company Act of 1956, which is not an investment company”<sup>93</sup> from the definition of investment advisers. This means that banks and bank holding companies are not subject to the registration, supervision, and regulation imposed by the IAA.<sup>94</sup> The SEC has taken the position, however, that non-bank affiliates of a bank are not exempt from IAA registration.<sup>95</sup> Moreover, any person providing investment advice to an investment company, for example a bank providing investment advice to a mutual fund, is subject to the restrictions on such activity found in the ICA.<sup>96</sup>

### C. Sources of Agency Enforcement Authority

Despite the bank exemptions found in the federal securities laws, banks must answer to significant securities law regulation. As discussed, the responsibility for administration of the securities laws is divided and shared between the SEC and the federal banking regulators. The agencies’ tools for the enforcement of those laws is discussed below.

#### 1. SEC Enforcement Powers

The SEC may seek injunctive relief in any U.S. district court for violations of the securities laws by banks and non-banks.<sup>97</sup> The SEC has the authority to bring administrative cease and desist proceedings for violations of the securities laws.<sup>98</sup> The SEC may also impose civil

incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks . . . , and which is supervised and examined by State or Federal authority having supervision over banks, and which is not operated for the purpose of evading the provision of this subchapter, and (D) a receiver, conservator, or other liquidating agent of any institution or firm included in clauses (A), (B), or (C) of this paragraph.

Investment Advisers Act of 1940 § 202(a)(2), 15 U.S.C. § 80b-2(a)(2) (1997).

92. *See id.* § 202(a)(11)(A), 15 U.S.C. § 80b-2(a)(11)(A).

93. *Id.*

94. *See id.* § 203, 15 U.S.C. § 80b-3.

95. *See FEIN, supra* note 62, § 10.03[E].

96. Investment Company Act of 1940 § 2(a)(20), 15 U.S.C. § 80a-2(a)(20) (defining an “investment adviser” of an investment company).

97. *See Securities Act of 1933* § 20(b), 15 U.S.C. § 77t(b) (1997); *Securities Exchange Act of 1934* § 21, 15 U.S.C. § 78u(d) (1997). *See generally* LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 4727-843 (3d ed. 1993).

98. *See Securities Act of 1933* § 8A, 15 U.S.C. § 77h-1; *Securities Exchange Act of 1934* § 21C, 15 U.S.C. § 78u(d)(3).

penalties.<sup>99</sup> The SEC may not utilize the enforcement authority provided under § 15C of the Exchange Act against a bank acting as a government securities broker or dealer.<sup>100</sup> The SEC, however, retains the authority to enforce other provisions of the securities laws against banks acting as government securities brokers or dealers.<sup>101</sup>

## 2. Bank Regulators' Enforcement Powers

Congress delegated enforcement authority of certain provisions of the federal securities laws to the federal banking regulators. For example, the federal banking regulators enforce various Exchange Act provisions relevant to transactions in banks' securities.<sup>102</sup> The federal banking regulators also enforce the laws regulating municipal securities brokers and dealers,<sup>103</sup> government securities brokers and dealers,<sup>104</sup> clearing agencies,<sup>105</sup> and transfer agents.<sup>106</sup> Under these securities law provisions, the federal banking regulators derive the authority to seek injunctive relief<sup>107</sup> and to impose administrative sanctions.<sup>108</sup>

The federal banking agencies take the position that they can bring enforcement proceedings under the Federal Deposit Insurance Act (FDIA) for violations of the federal securities law.<sup>109</sup> The FDIA, generally, provides the banking agencies with four types of

---

99. See Securities Exchange Act of 1934 §§ 21A, 21B, 15 U.S.C. §§ 78u-1, 78u-2.

100. See *supra* note 76 and accompanying text.

101. See Securities Exchange Act of 1934 § 15C(f)(2), 15 U.S.C. § 78o-5(g)(2).

102. See *id.* § 12(i), 15 U.S.C. § 78l(i). See discussion *supra* notes 48-49 and accompanying text.

103. See Securities Exchange Act of 1934 § 15B(c), 15 U.S.C. § 78o-4(c). See discussion *supra* note 70 and accompanying text.

104. See Securities Exchange Act of 1934 § 15C(g)(2), 15 U.S.C. § 78o-5(g)(2). See discussion *supra* note 76 and accompanying text.

105. See Securities Exchange Act of 1934 § 17A(d), 15 U.S.C. § 78q-1(d). See discussion *supra* note 80 and accompanying text.

106. See Securities Exchange Act of 1934 § 17A(d), 15 U.S.C. § 78q-1(d). See discussion *supra* note 85 and accompanying text.

107. See, e.g., Securities Exchange Act of 1934 § 21, 15 U.S.C. § 78u.

108. See, e.g., *id.* § 15B(c), 15 U.S.C. § 78o-4(c) (censure, suspension, and revocation of registration for municipal securities dealers); *Id.* § 15C(c)(2), 15 U.S.C. § 78o-5(c)(2) (censure, limitations on activities, and suspension for government securities brokers and dealers); *id.* § 17A(c)(3), 15 U.S.C. § 78q-1(c)(3) (censure limitations on activities, and suspension for transfer agents).

109. Under the OCC's enforcement policy, "[t]he OCC may pursue enforcement actions available under federal banking laws for securities law violations, when such actions provide a more effective or efficient enforcement vehicle." OCC, Securities Activities Enforcement Policy, PPM-5310-5, at 3 (July 7, 1993). The Fed and the FDIC apparently take the same position. See, e.g., *In re Robert L. McCook*, No. 96-027-B-I, Order by the Board of Governors of the Federal Reserve System (June 3, 1997) (entering cease and desist order under § 1818(b) of the FDIA for violations of NASD rules); *In re American City Bank of Tullahoma*, FDIC-95-2b, 1995 FDIC Enf. Dec. LEXIS 5 (Jan. 11, 1995) (entering cease and desist order under § 1818(b) of the FDIC for, among other things, violations of the Government Securities Act of 1986).



administrative enforcement:<sup>110</sup> termination of insurance,<sup>111</sup> cease and desist proceedings,<sup>112</sup> removal/suspension of individuals affiliated with banks,<sup>113</sup> and civil money penalties.<sup>114</sup> The cease and desist, removal/suspension, and civil money penalties provisions are all triggered by, among other things, violations of law or regulation. The FDIA cease and desist power can be invoked upon any finding that a bank is violating, or has violated, "a law, rule, or regulation."<sup>115</sup> For example, a cease and desist proceeding could be based on insider trading, because such activity would violate § 10(b) of the Exchange Act<sup>116</sup> and Rule 10b-5.<sup>117</sup>

It is not clear, however, that Congress intended the enforcement powers under the federal banking laws to apply, literally, to any violation of law or regulation. At least one court has suggested in dicta that the cease and desist authority may not reach that far. The Fifth Circuit, in interpreting the Federal Home Loan Bank Board's (FHLB)<sup>118</sup> cease and desist authority, suggested that the "cease and desist power would arise only when an association violates a law which protects the association's financial integrity."<sup>119</sup> In the above example, it would be difficult to argue that insider trading laws protect a bank's financial integrity because the purpose of such laws is investor protection. Therefore, if the Fifth Circuit's posited interpretation of the FHLB's cease and desist authority were extended by the Fifth Circuit or other circuits to the cease and desist power found in the FDIA, the federal banking agencies' interpretation of their cease and desist authority would be circumscribed.

Congress has provided some direct authority for the use of the FDIA enforcement powers for securities laws violations. Congress has

---

110. See generally Heidi Mandanis Schooner, *Fiduciary Duties' Demanding Cousin: Bank Director Liability for Unsafe or Unsound Banking Practices*, 63 GEO. WASH. L. REV. 175, 202-04 (1995).

111. See 12 U.S.C. § 1818(a) (1996).

112. See *id.* § 1818(b)(1).

113. See *id.* § 1818(c).

114. See *id.* § 1818(i)(2).

115. *Id.* § 1818(b)(1). Similarly, actions for removal from office can be based on a violation of "any law or regulation." *Id.* § 1818(e)(1)(A)(i)(I). Actions for civil money penalties can also be based on a violation of "any law or regulation." *Id.* § 1818(i)(2)(A)(i).

116. 15 U.S.C. § 78j(b) (1997). For an interesting discussion regarding whether the federal banking regulators have the authority to enforce directly § 10(b) (i.e., not through the banking laws) in the context of the trading of bank-issued securities, see Michael P. Malloy, *Can 10b-5 for the Banks? The Effect Of An Antifraud Rule On The Regulation Of Banks*, 61 FORDHAM L. REV. S23, S35-40 (1993).

117. See 17 C.F.R. § 240.10b-5 (1997).

118. In 1989, Congress replaced the Federal Home Loan Bank Board with the OTS as the federal regulator of savings associations. See 12 U.S.C. § 1463 (1996).

119. *Gulf Fed. Sav. and Loan Ass'n v. Federal Home Loan Bank Bd.*, 651 F.2d 259, 265 n.5 (5th Cir. 1981).

explicitly provided that FDIA cease and desist proceedings and actions for removal may be based on violations of §§ 15B,<sup>120</sup> 15C,<sup>121</sup> or 17A<sup>122</sup> of the Exchange Act. The existence of these explicit statutory linkages may suggest that Congress did not otherwise intend the banking regulators to use the FDIA to enforce the banking laws. It is just as likely, however, that Congress never considered the issue.

### III. CURRENT PARADIGM OF REGULATION OF BANK SECURITIES ACTIVITIES

Establishing the boundaries of regulation (i.e., to whom and to what should regulation apply) and dividing regulatory responsibility within those boundaries (i.e., which agency or agencies should administer the regulation) are complex determinations that involve a balancing of the benefits of regulation with its costs. Policy makers, scholars, and constituents have developed or adopted models to resolve these difficult questions. In the context of the regulation of bank securities activities, various models of regulation are generating debate. The two models of regulation that relate most to the current paradigm of regulation are functional regulation and institutional regulation. This Part begins with a discussion of the concept of functional regulation, focusing on how it can be distinguished from institutional regulation and the varying interpretations of the functional regulation model. This Part then considers the breadth and limits of the federal securities laws and the division of regulatory responsibility for the implementation of those laws and concludes that the current paradigm of bank regulation combines elements of functional regulation and elements of institutional regulation. Once consideration is given to actual bank securities activities, however, the current model of regulation can be cast as the functional equivalent to functional regulation.

#### *A. Distinguishing Functional Regulation from Institutional Regulation*

The term "functional regulation" describes various, related models of regulation. Today, the concept of functional regulation enjoys such popularity on Capitol Hill that its utterance insinuates sensible, modern, regulatory reform.<sup>123</sup> Functional regulation has also earned some

---

120. Securities Exchange Act of 1934 § 15B(c)(5), 15 U.S.C. § 78o-4(c)(5) (1997).

121. *Id.* § 15C(c)(2)(B), 15 U.S.C. § 78o-5(c)(2)(B).

122. *Id.* § 17A(d)(2), 15 U.S.C. 78q-1(d)(2).

123. In 1997 alone, the following testimony before congressional committees and subcommittees indicated support for a functional regulation approach to financial modernization, see Dino Gavanis,

---

Principal, Premier Risk Services, Inc., Before the Subcomm. on Finance and Hazardous Materials of the House Comm. on Commerce (June 24, 1997); Glenn Pomeroy, Commissioner of Insurance for the State of North Dakota, Before the Subcomm. on Finance and Hazardous Materials of the House Comm. on Commerce (June 24, 1997); John D. Hawke, Jr. Treasury Under Secretary for Domestic Finance, Before the House Comm. on Banking and Financial Services (June 3, 1997); Nicolas Retsinas, Director, OTS, Before the House Comm. on Banking and Financial Services (May 22, 1997); Mary Griffin, Insurance Counsel, Consumers Union, Before the House Comm. on Banking and Financial Services (May 21, 1997); John E. Taylor, President and CEO of the National Community Reinvestment Coalition, Before the House Comm. on Banking and Financial Services (May 21, 1997); William V. Irons, Irons and Associates, Before the House Comm. on Banking and Financial Services (May 14, 1997); Brent Larsen, Chair, Financial Services Task Force of the National Association of Mutual Insurance Companies, Before House Comm. on Banking and Financial Services (May 14, 1997); Robert A. Gleason, Jr., On Behalf of The Council of Insurance Agents & Brokers, Before the House Comm. on Banking and Financial Services (May 14, 1997); Brandon Becker, Before the Subcomm. on Finance and Hazardous Materials of the House Comm. on Commerce (May 14, 1997); Arthur Levitt, Chairman, SEC, Before the House Comm. on Banking and Financial Services (May 22, 1997); George Nichols, III, Commissioner of Insurance for the Commonwealth of Kentucky, Before the House Comm. on Banking and Financial Services (May 22, 1997); Denise Voigt Crawford, President-Elect, North American Securities Administrators Association, Before the House Comm. on Banking and Financial Services (May 22, 1997); John G. Heimann, Chairman of Global Financial Institutions, Merrill Lynch & Co., Inc., Before the House Comm. on Banking and Financial Services (May 14, 1997); Paul A. Volcker, Before the House Comm. on Banking and Financial Services (May 14, 1997); Christine A. Edwards, On Behalf of Financial Services Council, Before the House Comm. on Banking and Financial Services (May 14, 1997); Marc Lackritz, President, Securities Industry Association, Before the House Comm. on Banking and Financial Services (May 14, 1997); Jeffrey A. Tasse, On Behalf of the American Financial Services Association, Before the House Comm. on Banking and Financial Services (May 14, 1997); Michael P. Grace, President, National Association of Professional Insurance Agents, Before the House Committee on Banking and Financial Services (May 14, 1997); Matthew P. Fink, President, Investment Company Institute, Before the House Comm. on Banking and Financial Services (May 14, 1997); Dan R. Wentzel, President, American Land Title Association, Before the House Comm. on Banking and Financial Services (May 14, 1997); Richard C. Breeden, President, Richard C. Breeden & Co., Before the Subcomm. on Finance and Hazardous Materials for the House Comm. on Commerce (May 14, 1997); William T. McConnell, President-Elect, American Bankers Association, Before the House Comm. on Banking and Financial Services (May 7, 1997); Arnold D. Scott, Senior Executive Vice President, Massachusetts Financial Services, Before the Subcomm. on Financial and Hazardous Materials for the House Comm. on Commerce (May 1, 1997); James R. Klagholz, On Behalf of the Independent Insurance Agents of America, Before the Subcomm. on Financial Institutions and Consumer Credit of the House Comm. on Banking and Financial Services (Feb. 11, 1997); Chairman D'Amato, Before the Subcomm. on Financial Institutions of the Senate Comm. on Banking (May 1, 1997); Mark Pope, Vice President and Director of Federal Government Relations, Lincoln National Corporation, Before the Subcomm. on Finance and Hazardous Materials of the House Comm. on Commerce (May 1, 1997); James F. Higgins, President and Chief Operating Officer, Dean Witter Financial, Before the Subcomm. on Finance and Hazardous Materials of the House Comm. on Commerce (May 1, 1997); Cheryl Cook-Schneider, Principal, Edward D. Jones & Co., Before the Subcomm. on Finance and Hazardous Materials of the House Comm. on Commerce (May 1, 1997); Mark B. Sutton, Executive Vice President, Paine Webber Group, Inc., Before the Subcomm. on Finance and Hazardous Materials of the House Comm. on Commerce (May 1, 1997); W. Craig Zimpler, Vice President of Government Relations, Nationwide Insurance Enterprise, Before the Subcomm. on Finance and Hazardous Materials of the House Comm. on Commerce (May 1, 1997); Roy C. Albertalli, On Behalf of the American Council of Life Insurance, Before the Subcomm. on Financial Institutions and Consumer Credit of the House Comm. on Banking (Feb. 11, 1997); Samuel J. Baptista, President, Financial Services Council, Before the Subcomm. on Financial Institutions and Consumer Credit for the House Comm. on Banking and Financial Services (Feb. 11, 1997).

amount of scholarly support.<sup>124</sup>

Defining "functional regulation" begins most easily with defining what it is not. Functional regulation is not institutional regulation. Under a pure model of institutional regulation, or entity regulation, the scope of regulation is determined according to institution type; for example, banks are governed under the banking laws and those laws are administered by bank regulators; securities firms are governed by the federal securities laws and those laws are administered by the SEC.<sup>125</sup> Functional regulation rejects the institutional regulation model and provides that scope of regulation should be divided according to activity;<sup>126</sup> for example, all entities engaged in securities activities, regardless of the form of the entity, should be governed by the federal securities laws and those laws should be administered by a single regulator, the SEC.<sup>127</sup>

Functional regulation is said to be desirable because it provides consistency. No matter what type of institution is involved in a particular activity, the same rules apply. This provides a level playing field to institutions operating within the industry and consistent protections to consumers. Functional regulation also provides for a system that allows for the development of expert agencies with the sole responsibility for administering laws within their field of specialization. This avoids, for example, the creation of securities divisions within each of the federal banking regulators.<sup>128</sup>

---

It is much more difficult to find testimony before congressional committees or subcommittees that is at all critical of the functional model. For examples in 1997, see Ricki Helfer, Chairman, FDIC, Before the House Comm. on Banking and Financial Services (May 22, 1997); G. Edward Leary, Commissioner of Financial Institutions for the State of Utah, Before the House Comm. on Banking and Financial Services (May 22, 1997).

124. Jane E. Willis, *Banks and Mutual Funds: A Functional Approach to Reform*, 1995 COLUM. BUS. L. REV. 221 (1995); Paul A. Caldarelli, *Bank Growth in the Investment Company Industry: Do Guidelines Issued by the Comptroller of the Currency Compensate For Bank Exclusion from Statutory Provisions of the Federal Securities Laws Defining "Broker/Dealer" and "Investment Adviser"?*, 17 CAMPBELL L. REV. 11 (1995); Stephen J. Friedman & Connie M. Friesen, *A New Paradigm for Financial Regulation: Getting from Here to There*, 43 MD. L. REV. 413 (1984). But see Bert Ely, *Functional Regulation Flunks: It Disregards Category Blurring*, AM. BANKER, Feb. 21, 1997, at 4 (functional regulation is unworkable because of technological advances); *Interview: Steven Wallman*, THE FINANCIAL REGULATOR, June 1, 1997 [hereinafter *Wallman*] (functional regulation is outdated).

125. Although banks' insurance activities are beyond the scope of this Article, under the institutional model, banks' insurance activities would be regulated by the appropriate state insurance agency.

126. Alan Greenspan has described functional regulation "as a system in which each separate 'function'—such as commercial banking, investment banking, or mortgage banking—is supervised by the same regulatory body, regardless of the function's location within a particular financial institution." Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, Remarks Before the 31st Annual Conference on Bank Structure and Competition (May 11, 1995).

127. Similarly, one could argue that, when any entity engages in deposit-taking activity, it should be regulated by one regulator, presumably the bank regulators.

128. The functional regulation model also avoids the possibility of regulatory competition which

The principle flaw of the functional regulatory model is that separating the functions or activities of an institution, and assigning different laws and agencies to those functions, creates a situation in which no regulator has an overall picture of the institutions' operations and how the overall operations impact regulatory goals. Moreover, the functional model, by definition, requires the regulated institution to answer to multiple regulators. This results potentially in increased costs for the regulated institutions which are avoided under the institutional model.<sup>129</sup> Finally, the functional model presupposes the ability to identify and divide activities, i.e., it assumes a distinction between securities products, depository products, and insurance products. In practice, however, particularly with the development of increasingly complex financial instruments, it is often difficult to label financial products.<sup>130</sup>

The application of the functional regulation model is multifaceted. As with any model that seeks to address the scope of regulation, the functional regulation model addresses two fundamental issues. First, a model of regulation must address the parameters of the substantive law at issue. This Article refers to this issue as one of *regulatory breadth*. In the context of banks' securities activities, the question of regulatory breadth addresses whether banks should be subject to the same laws as non-bank financial institutions.<sup>131</sup> Under the functional model, the federal securities laws would be applied to banks' securities activities without exception.

Second, a model of regulation must address the division of responsibility for implementation of substantive laws among agencies. This Article refers to this issue as one of *regulatory division*. With regard to banks' securities activities, the question of regulatory division asks which regulator is responsible for administering the substantive law

---

results when more than one regulatory has the responsibility for administering a regulatory scheme. With regard to traditional bank activities, the current system fosters competition between the regulators because there are multiple agencies charged with administering the federal banking laws. The benefits and existence of regulatory competition have been the source of much debate. See Arthur E. Wilmarth, Jr., *The Expansion of State Bank Powers, The Federal Response, and The Case For Preserving the Dual Banking System*, 58 FORDHAM L. REV. 1133, 1241-42 (1990); Henry N. Butler & Jonathan R. Macey, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677 (1988); Kenneth E. Scott, *The Dual Banking System: A Model of Competition in Regulation*, 30 STAN. L. REV. 1 (1977).

129. Such costs include those created by duplicative supervision and also those created, in some cases, by conflicting supervision.

130. It took a decision by the United States Supreme Court to determine that annuities are not insurance. See *NationsBank of N.C., N.A. v. Variable Annuity Life Ins. Co.*, 513 U.S. 251 (1995).

131. Under the functional model, the converse is, of course, also true. In other words, to the extent that non-bank firms were to engage in deposit-taking activities, they would be regulated under banking laws.

regulating those activities. Under the functional model, the SEC would be responsible for administering laws that relate to securities activities and the bank regulators would be responsible for administering laws regulating banking activities.

In addition to serving as a model to address the issues of regulatory breadth and regulatory division, the functional model has been used to support the position that different activities within a financial organization should be segregated into separate legal entities—subsidiaries or affiliated entities—because such separation facilitates the functional approach.<sup>132</sup> Finally, functional regulation has also been used to refer to a regulatory model that eliminates an umbrella regulatory function in that it seeks to regulate specific products or activities as opposed to overall operations.<sup>133</sup>

### *B. The Breadth and Division of Regulatory Responsibility Under the Current Regime*

The functional and institutional regulation models can be used to divine the current regulatory regime governing banks' securities activities. Although the regulation of bank securities activities appears to have been modeled on the basis of combining functional and institutional regulatory elements, once actual bank practices are taken into consideration, the form of regulation takes on a more functional shape. This subpart explores the current regulatory regime first by looking at the issue of regulatory breadth, and then by considering the issue of regulatory division.

---

132. Greenspan, *supra* note 126. In reality, a model that segregates activities into separate legal entities is a combination of institutional regulation and functional regulation in that the division of regulatory responsibility coincides with the division of activities among entities. The Comptroller has criticized this approach as too restrictive on the prerogative of businesses to decide how to structure their corporations. See *Financial Services Restructuring: Hearings on H.R. 10 Before the House Comm. on Banking and Finan. Services*, 105th Cong. (1997) (statement of Eugene A. Ludwig, Comptroller of the Currency) (commenting on provisions of H.R. 10). It is no surprise that the Fed would support this type of functional regulation because it would likely push securities activities of banks out of the bank itself and into an entity that would be regulated by the Fed, for example, a § 20 subsidiary. See *supra* notes 25-32 and accompanying text (discussing § 20 subsidiaries).

133. See *Financial Services Competitiveness Act: Hearings on H.R. 1062 Before the House Comm. on Banking and Finan. Services*, 104th Cong. (1995) (statement of James L. Bothwell, Director, Financial Institutions and Markets Issues, GAO).

## 1. Regulatory Breadth

In the last fifteen years, as banks have become increasingly involved in the securities business,<sup>134</sup> the issue of regulatory breadth (the extent to which the federal securities laws apply to the securities activities of banks) has become more significant. Under many provisions of the federal securities laws, Congress has taken a functional approach to the application of the securities laws to banks' securities activities. The antifraud provisions of both the Securities Act and the Exchange Act apply to banks.<sup>135</sup> The securities registration provisions of the Exchange Act apply to securities issued by banks.<sup>136</sup> Banks are subject to securities law regulation of municipal securities and government securities brokers and dealers.<sup>137</sup> Banks are governed by securities law regulation of transfer agents.<sup>138</sup>

The most obvious deviations from Congress's functional approach are the exemptions for banks from the registration requirements under the Securities Act,<sup>139</sup> the broker and dealer registration and supervision under the Exchange Act,<sup>140</sup> and the registration and supervision of investment advisors under the IAA.<sup>141</sup> Except with respect to application of the anti-fraud provisions, these bank securities activities are not regulated under the securities laws.

Given this statutory scheme, one could conclude that Congress created a system of regulation that utilizes both functional and institutional regulation in determining regulatory breadth. Once consideration of banks actual securities activities is added into the equation, it appears that the breadth of regulation falls substantially into a functional mode — with the possible exception of the exemption from the IAA.

---

134. According to a report by the American Banker's Association:

While some banking institutions were involved in discount brokerage and other limited securities activities prior to the 1980s, it is generally agreed that the bank retail investment services industry began in the early 1980s and is, accordingly, about 15 years old. Banking institutions have become active participants in the retail distribution of securities products over that period.

AMERICAN BANKERS ASSOCIATION, 1996 NATIONAL SURVEY OF BANK RETAIL INVESTMENT SERVICES, 9 (1997) [hereinafter 1996 SURVEY].

135. See *supra* note 54 and accompanying text.

136. See *supra* note 47 and accompanying text.

137. See *supra* notes 63-76 and accompanying text.

138. See *supra* note 82 and accompanying text.

139. See *supra* note 42 and accompanying text.

140. See *supra* notes 59-62 and accompanying text. Banks may be exempt from clearing-agency regulation if their activities in that area are limited. See *supra* notes 77-81 and accompanying text.

141. See *supra* notes 91-96 and accompanying text.

The bank exemption from the registration requirements of the Securities Act only benefits (in terms of avoiding regulation) banks whose securities are publicly held. To the extent that the securities of most banks are owned by bank holding companies,<sup>142</sup> the registration requirements would have no application even without the bank exemption. Therefore, the exemption does not have the actual impact suggested from the language of the statute.

The bank exemption from broker and dealer regulation under the Exchange Act only benefits those banks operating broker and dealer activities in the bank itself. Given the restrictions of the Glass-Steagall Act, banks must conduct many securities activities in a bank subsidiary or non-bank affiliate.<sup>143</sup> Broker and dealer activities conducted in a bank subsidiary or non-bank affiliate of a bank are subject to the full range of Exchange Act regulation.

As to those securities activities that are permissible at the bank level, for example, retail brokerage, very few banks conduct such activities in the bank itself.<sup>144</sup> The vast majority of banks conduct those activities through a registered broker and dealer subject to the full scheme of Exchange Act regulation.<sup>145</sup> In practice, therefore, the broker and

---

142. The Fed reports that at year-end 1996, bank holding companies "controlled 7,213 insured commercial banks and held approximately 93 percent of the assets of all insured commercial banks in the United States." Board of Governors of the Federal Reserve System, 83RD ANNUAL REPORT, at 227 (May 28, 1997) <<http://www.bog.frb.fed.us/boarddocs/RptCongress/annual96/annual.pdf>>. At year-end 1996, there were 9,997 banks. *See id.* at 314. Therefore, 72% of banks are controlled by bank holding companies. One cannot conclude that none of the 7,213 banks controlled by bank holding companies issue securities to the public, but it is likely that most do not.

With regard to the 2,784 banks that are not controlled by bank holding companies, it is probable that these are small institutions (to the extent they hold only 7% of all bank assets) and that many of them are privately held.

143. *See supra* Part I.

144. In 1995, the General Accounting Office reported that only 287 banks, or about 12% of banks, provided securities brokerage directly through the bank, i.e., on bank premises and through bank employees. *See GAO, Banks' Securities Activities: Oversight Differs Depending on Activity and Regulator*, GAO/GGD-95-214 (Sept. 1995). On the other hand, in 1996, the SEC supervised approximately 8,500 broker-dealers. 1996 SEC Ann. Rep., at 39.

More recently, the American Bankers Association issued a report concluding that only 1.7% of banking institutions (including commercial and savings banks, savings associations, and credit unions) provided discount brokerage directly through the bank. *See* 1996 SURVEY, *supra* note 134, at 29. The report also concludes that only 1.0% of banking institutions provide full service brokerage directly through the bank. *Id.*

145. For example, the American Bankers Association has found that, with regard to discount brokerage services, 23.9% of banking institutions (including commercial and savings banks, savings associations, and credit unions) provide such service through a bank or holding company owned subsidiary, and 70.8% of banking institutions provide such service through a third-party brokerage or marketing company. *See id.* Brokerage activities conducted by these entities are subject to full federal securities law regulation, administered by the SEC.



dealer activities of banking organizations are regulated predominantly on a functional basis.

The picture differs slightly with regard to the bank and bank holding company exemption from the IAA. In recent years, banks have acquired a more significant role in providing investment advice to registered investment companies. Although the numbers of banks providing investment advice is not significant,<sup>146</sup> these banks are advising a significant portion of registered investment companies.<sup>147</sup> Therefore, the regulatory gap created by the IAA exemption is not narrowed in light of actual bank practices.

## 2. Regulatory Division

The division of regulation governing bank securities activities involves not only the question of whether a bank regulator or the SEC will administer securities regulation, but also which of the many bank regulators—the Fed, OCC, FDIC, or the Office of Thrift Supervision (OTS)—will have responsibility. Bank regulation in this country has been divided at the federal level between and among various agencies. Under the dual banking system,<sup>148</sup> a bank may receive a charter from either a state government or the federal government. Federal regulatory responsibility under the federal banking laws is divided on the basis of whether a bank is a state chartered bank or a federally chartered bank (national bank).<sup>149</sup> Federal regulatory responsibility under the federal banking law is also divided according to whether or not a state bank is a member of the Federal Reserve System.<sup>150</sup> Federal regulatory

---

146. According to SEC Chairman Levitt, as of December 31, 1996, 119 banks were providing investment advice to funds. See Arthur Levitt, Chairman, SEC, Before the House Committee on Banking and Financial Services Subcommittee on Financial Institutions and Consumer Credit (Feb. 13, 1997). The total number of banks as of December 31, 1996, was 9,490. See Board of Governors of the Federal Reserve System, 83RD ANNUAL REPORT, *supra* note 141, at 314.

147. According to SEC Chairman Levitt, "[a]s of December 31, 1996, 119 banks advised 2857 funds (including individual classes), representing approximately 28% of all funds registered with the Commission. Also as of that date, assets of bank-advised funds totaled \$493.2 billion, or 15% of total mutual fund assets." Levitt, *supra* note 145.

148. For a general discussion of the dual banking system, see Heidi Mandanis Schooner, *Recent Challenges to the Persistent Dual Banking System*, 41 ST. LOUIS U. L.J. 263 (1996).

149. The OCC is the primary federal regulator for all nationally chartered commercial banks. See 12 U.S.C. §§ 26, 93a (1994). Regulatory responsibility for state chartered banks is divided between the FDIC and the Fed. See *infra* note 40.

150. The Fed is the primary federal regulator for state chartered commercial banks that are members of the Federal Reserve System and for bank holding companies. See 12 U.S.C. §§ 248, 1844. The FDIC is the primary federal regulator for state chartered banks that are not members of the Federal Reserve System. See *id.* § 1813(q)(3). In addition, the FDIC has the ability, under certain circumstances, to bring enforcement actions against any insured bank and its officers, directors, and other affiliated professionals.

responsibility is further divided on the basis of whether the institution is a commercial bank or a savings association.<sup>151</sup>

Congress has followed a model of institutional regulation of bank securities activities to the extent that it has granted the banking agencies power to administer the securities laws in some important areas. Responsibility for administration of these provisions of the securities laws falls on the primary regulator of the institution. For example, the federal banking agencies, rather than the SEC, administer various provisions of the Exchange Act regarding banks' registered securities.<sup>152</sup> The federal banking agencies are primarily responsible for administering the securities law regulation of government securities dealers,<sup>153</sup> municipal securities dealers,<sup>154</sup> clearing agencies,<sup>155</sup> and transfer agents.<sup>156</sup>

The SEC retains the authority to enforce the antifraud provisions.<sup>157</sup> The SEC and the federal banking agencies share enforcement authority with regard to banks acting as municipal securities brokers and dealers.<sup>158</sup> In addition, the SEC has backup enforcement authority with regard to banks acting as clearing agencies or transfer agents.<sup>159</sup>

The statutory framework appears more closely modeled on an institutional framework rather than a functional one. If regard is limited to actual bank activities, that perspective is altered considerably, particularly with respect to the regulation of municipal securities dealers and government securities dealers. For example, while the federal banking agencies have the authority to administer the securities registration provisions under the Exchange Act, very few banks have registered securities.<sup>160</sup> Similarly, only a small fraction of banks are

---

*See id.* § 1818(t).

151. The OTS is the primary federal regulator for savings associations. *See id.* § 1463.

152. *See supra* note 48 and accompanying text.

153. *See supra* note 76 and accompanying text.

154. *See supra* note 70 and accompanying text.

155. *See supra* note 80 and accompanying text.

156. *See supra* note 85 and accompanying text.

157. *See supra* note 55 and accompanying text.

158. *See supra* note 70 and accompanying text.

159. *See supra* note 81 and accompanying text.

160. In 1996, 36 state member banks had registered securities, *see* Board of Governors for the Federal Reserve System, 82ND ANNUAL REPORT, *supra* note 141, at 246; 191 state nonmember banks had registered securities, *see* Securities of Nonmember Insured Banks, 61 Fed. Reg. 33,696 (1996) (to be codified at 12 C.F.R. pt. 335) (proposed June 28, 1996); and 42 national banks had registered securities. Telephone Interview with Unnamed OCC Employee (July 1997) [hereinafter OCC Interview]. This represents 3.5% of the 1,014 state member banks, 3.2% of the 5,789 state nonmember banks, and 1.5% of the 2,687 national banks. By way of comparison, in 1995, the total number of companies required to file reports with the SEC under the Exchange Act was 12,753. *See* SEC, Directory of Companies Required to File Annual Reports With the Securities and Exchange Commission Under the Securities Exchange Act of 1934 (Sept.

acting as municipal securities brokers and dealers,<sup>161</sup> and government securities brokers and dealers.<sup>162</sup> While it is also true that only a small fraction of banks are acting as clearing agencies<sup>163</sup> or transfer agents,<sup>164</sup> their numbers represent a significant portion of all institutions acting as clearing agencies<sup>165</sup> or transfer agents.<sup>166</sup> In sum, the bank regulators' responsibilities under the federal securities laws inure to few regulatees. Except with regard to clearing agencies and transfer agents, the few that are regulated by bank regulators represent a small fraction of their regulated peer groups.

### 3. Breadth and Division Taken Together

As a result of the convergence of Glass-Steagall restrictions<sup>167</sup> on banks' securities activities and the limited nature of the exemptions provided under the securities laws,<sup>168</sup> the federal securities laws establish a system of regulation that combines the functional and institutional models. Viewed in light of current banking practices, however, the current operating model of regulation is much closer to a functional

30, 1995).

161. In 1996, 38 state member banks were acting as municipal securities brokers or dealers. *See* Board of Governors for the Federal Reserve System, 82ND ANNUAL REPORT, *supra* note 141, at 230. This represents 3.7% of the 1,014 state member banks. In 1996, 30 state nonmember banks were acting as municipal securities brokers or dealers. Telephone Interview with Unnamed FDIC Employee, Securities Capital Markets and Trust Branch (July 1997) [hereinafter FDIC Interview]. This represents .5% of the 5,789 state non-member banks. In 1996, 75 national banks were acting as municipal securities brokers or dealers. OCC Interview, *supra* note 160. This represents 2.7% of the 2,687 national banks.

162. In 1996, 42 state member banks were acting as government securities brokers or dealers. *See* Board of Governors for the Federal Reserve System, 82ND ANNUAL REPORT, *supra* note 141, at 229-30. This represents 4.1% of the 1,014 state member banks. In 1996, 28 state nonmember banks were acting as government securities brokers or dealers. FDIC Interview, *supra* note 161. This represents .4% of the 5,789 state nonmember banks. In 1996, 83 national banks were acting as government securities brokers or dealers. OCC Interview, *supra* note 160. This represents 3% of the 2,687 national banks.

163. In 1996, 3 state member banks were acting as clearing agencies. *See* Board of Governors for the Federal Reserve System, 82ND ANNUAL REPORT, *supra* note 141, at 230. This represents .02% of the 1,014 state member banks. In 1996, no state nonmember banks or national banks were acting as clearing agencies. FDIC Interview, *supra* note 161; OCC Interview, *supra* note 160.

164. In 1996, 170 state member banks were acting as transfer agents. *See* Board of Governors for the Federal Reserve System, 82ND ANNUAL REPORT, *supra* note 141, at 231. This represents 16.7% of the 1,014 state member banks. In 1996, 163 state non-member banks were acting as transfer agents. This represents 2.8% of the 5,789 state non-member banks. In 1996, 287 national banks were acting as transfer agents. OCC Interview, *supra* note 160. This represents 10.6% of the 2,687 national banks.

165. In comparison to the 3 clearing agencies supervised by the federal banking regulators, *see supra* note 163, the SEC supervised 15 registered clearing agencies in 1996. *See* 1996 SEC Ann. Rep., at 39.

166. In comparison to the 620 transfer agents supervised by the federal banking regulators, *see supra* note 164, the SEC supervised 748 transfer agents in 1996. *See* 1996 SEC Ann. Rep., at 39.

167. *See supra* Part I.

168. *See supra* Part II.

model than an institutional one—a functional equivalent of functional regulation. Whether it is due to Glass-Steagall restrictions, business expediency, or perceived risk aversion, banks generally have not conducted their securities business in the bank itself. Thus, the securities laws generally apply (and the SEC generally administers those laws) to securities activities conducted by banks because those activities are housed in a bank subsidiary or non-bank affiliate of the bank. With respect to regulation of transactions in a bank's own securities, again, an insignificant number of banks issue publicly traded securities. To the extent that the institutional model is employed in our current system, little actual securities regulation occurs under that format.

#### IV. TODAY: THE FUNCTIONAL EQUIVALENT TO FUNCTIONAL REGULATION SUFFICES

Given the traditional goals of regulating financial institutions and the current modest level of securities activities conducted by banks themselves, this Part seeks to evaluate the effectiveness of the current model of regulating banks' securities activities. This Part concludes that the current model of regulation, the functional equivalent of functional regulation, provides an acceptable compromise between the benefits of functional regulation and those of institutional regulation given the current level and structure of banks' securities activities.<sup>169</sup>

##### *A. Traditional Regulatory Goals and Methods*

The macro-level challenge to the regulation of bank securities activities is identifying a model that can serve the arguably very different goals of regulating the banking industry versus the securities industry.

The primary purpose of bank regulation is the maintenance of the safety and soundness of banking institutions.<sup>170</sup> This translates into more

---

169. Part V concludes that the current model, and models for reform that aspire towards more pure functional regulation, will not prove enduring for the future.

170. The OCC's mission statement provides that "[t]he Office of the Comptroller of the Currency serves [the national] interest by maintaining and promoting a system of bank supervision and regulation that promotes safety and soundness by requiring that national banks adhere to sound management principles and comply with the law . . . ." OCC, *Mission Statement* (visited July 10, 1997) <<http://www.occ.treas.gov/mission.htm>>.

In addition to its role in regulating state nonmember banks, the FDIC has the unique role as deposit insurer. Therefore, the FDIC's mission statement is focused on protection of the deposit insurance funds. The FDIC's mission statement provides that "the FDIC promotes the safety and soundness of insured depository institutions and the U.S. financial system by identifying, monitoring, and addressing risks to the deposit insurance funds." FDIC Strategic Plan 1998-2002 (visited July 10, 1997)

than protecting insured deposits: banks have been said to occupy a "special" role in our financial system.<sup>171</sup> Because of banks' special role, regulation of banks has sought to preserve the institutions themselves often by protecting banks from normal market forces.<sup>172</sup> Traditional bank regulation, therefore, has focused not only on the protection of insured, or even uninsured deposits, but also on the safeguarding of the banking system.<sup>173</sup>

Distinctly, the primary purpose of regulation of securities activities is investor protection. Certainly, the goal of investor protection has extensive overlap with safety and soundness goals to the extent that guarding the safety and soundness of an institution should also result in the protection of investor interests. Traditional securities regulation, however, does not take the next step. The goal of the federal securities laws is not to protect institutions from failure.<sup>174</sup> Therefore, investor protection under the securities laws is achieved, primarily, through a system that seeks to ensure the fairness of the securities markets, but not the solvency of the players in those markets.<sup>175</sup>

<<http://www.fdic.gov/about/strplan.html#Mission>>.

171. Gerald Corrigan, of the Federal Reserve Bank of Minneapolis, is credited with coining the "banks are special" argument. See GERALD CORRIGAN, FEDERAL RESERVE BANK OF MINNEAPOLIS, ARE BANKS SPECIAL? ANNUAL REPORT (1982). Corrigan argued that banks are special because they issue transaction accounts, they serve as a backup source of liquidity for all other institutions, and they serve as the transmission belt for the Fed's monetary policy (by lending more money to their customers when reserve requirements are lower, and less money when reserve requirements are raised). See *id.*

172. Certainly, in recent years of deregulation, much of the insulation from market forces that banks once enjoyed has been dismantled. For example, bank were once freed from competition on interests rates. The passage of the Depository Institution Deregulation and Monetary Control Act of 1980, Pub. L. 96-221, Title VII, § 707(a), 94 Stat. 188, eliminated this barrier from competition. In addition, attempts have been made to remove the "too big to fail" rule from bank regulatory culture. In 1991, Congress passed the Federal Deposit Insurance Improvement Act (FDICIA) which provided, *inter alia*, that the FDIC must apply the "least cost test" to decisions regarding the resolution of insolvent institutions. Specifically, FDICIA provides that the FDIC must determine that its actions are "the least costly to the deposit insurance fund of all possible methods for meeting the [FDIC's] obligation[s]." 12 U.S.C. § 1823(c)(4)(A)(ii) (1994). Significantly, however, the least cost test does not apply if the application of the test "would have serious adverse effects on economic conditions or financial stability" and upon written recommendation of the Board of Directors of the FDIC, the Board of Governors of the Fed, and the Secretary of the Treasury. *Id.* § 1823(c)(4)(G).

173. The OCC's mission statement provides that "[t]he national interest requires that there be a safe and stable financial system that preserves public confidence and makes available a wide variety of financial services in a competitive marketplace." OCC, *Mission Statement* (visited July 10, 1997) <<http://www.occ.treas.gov/mission.htm>>. The Fed states that it works to "ensure safety and soundness in the operation of financial institutions, stability in the financial markets, and fair and equitable treatment of consumers in their financial transactions." BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, THE FEDERAL RESERVE SYSTEM: PURPOSES AND FUNCTIONS 71(8th ed. 1994).

174. There are exceptions. For example, the ICA imposes capital requirements on investment companies. Section 18 of the ICA, 15 U.S.C. § 80a-18.

175. The SEC states that the purpose of the federal securities laws "is to protect investors in securities markets that operate fairly and to ensure that investors have access to disclosure of all material information

Historically, the banking regulators and the SEC have employed very different methods toward achieving their regulatory goals. The regulation of banks has been grounded primarily in a prophylactic system that entails outright restrictions on activities<sup>176</sup> and heavy monitoring of permissible activities, including regular on- and off-site monitoring of individual institutions.<sup>177</sup> In sharp contrast, the regulation of the securities industry has been grounded in mandatory disclosure.<sup>178</sup> Actual monitoring of activities is much less frequent<sup>179</sup> and review of filings is based on a sampling.<sup>180</sup> Heavy use of enforcement authority is used as a deterrent.<sup>181</sup>

### B. Evaluation of the Current Paradigm

As discussed in Part III, the current paradigm of regulation of banks' securities activities is, with exceptions, predominantly a model of functional regulation. Congress established the current system under the traditional regulatory goals: safety and soundness and investor protection. The current system, however, was established at a time when banks' securities activities were virtually nonexistent. The increase in activity over the last fifteen years calls into consideration the effectiveness of the current model.

---

concerning publicly traded securities." *The U.S. Securities and Exchange Commission: What It Is, What It Does* (visited July 10, 1997) <<http://www/sec.gov/asec/asecart.html>>.

176. Professor Garten has concluded that, in recent years, bank regulators have begun to rely less on outright prohibitions on activities and more on risk management to ensure safety and soundness. See Helen A. Garten, *Regulatory Growing Pains: A Perspective On Bank Regulation In a Deregulatory Age*, 57 *FORDHAM L. REV.* 501 (1989).

177. As of 1993, every insured depository institution must be examined at least once a year, with an exception for smaller institutions which must be examined at least every 18 months. See Federal Deposit Insurance Corporation Act, § 111 (1991) (codified at 12 U.S.C. § 1820(d) (1994)).

178. See *supra* note 175.

179. In response to the growth in the mutual fund industry, the SEC recently increased its inspection staff and has continued to achieve its goal of inspecting families of mutual funds at least every five years. See GAO, *Mutual Funds*, *supra* note 3, at 7.

180. In 1996, the SEC reviewed 26% of the filings of reporting issuers. See 1996 SEC Ann. Rep., at 78.

181. In 1996, the SEC initiated 453 enforcement actions. See 1996 SEC Ann. Rep., at 1. In contrast, the FDIC initiated 105 enforcement actions in 1995, see 1995 FDIC ANN. REP. 21; the Fed initiated 133 enforcement cases involving 285 actions in 1996, see Board of Governors for the Federal Reserve System, 83RD ANNUAL REPORT, *supra* note 141, at 228; and the OCC initiated 79 enforcement actions in 1996, see EUGENE A. LUDWIG, OFFICE OF THE COMPTROLLER OF THE CURRENCY, QUARTERLY JOURNAL VOL. 16 NO. 1 (1997).

### 1. Evaluation of Current Regulatory Breadth

As discussed above, the federal securities laws, in large part, apply to bank securities activities. At first blush, common sense suggests that the federal securities laws should apply, without exception, to bank securities activities in the same way they apply to the same activities when conducted by a non-bank. For the most part, they do. Part III concludes that some of the exceptions (for example, bank-direct broker and dealer activities) are small in terms of the actual volume of activity involved.<sup>182</sup> That conclusion may suggest that the exceptions do not merit debate or reform, or that the exceptions are not worthy of special attention. Worthy or not, the exceptions have been the subject of much critique.<sup>183</sup>

The traditional justification for the special exceptions under the federal securities laws for certain bank securities activities is that banks are already subject to comprehensive regulation. Another layer of regulation, therefore, would be largely repetitive and unduly onerous. Certainly, it is not unusual for a regulatory scheme to rely on a different regulatory system to achieve its goals. The banking laws currently rely, in part, on the effectiveness of foreign government supervision of foreign banks to protect those dealing with branches of such foreign banks established in the United States.<sup>184</sup> There is no definitive reason why the regulation of securities activities could not rely on a parallel system of regulation to achieve its goals. One might even ask why the bank exceptions are not broader. Banks are subject to far greater actual supervision than the non-banks involved in the securities markets.<sup>185</sup>

The issue then becomes whether safety and soundness based regulation achieves sufficiently the goals of regulating securities activities. To be sure, safety and soundness based regulation provides investor protection. It provides, however, a different kind of investor protection than the disclosure based regulation that is at the core of the securities laws. For example, an investor who purchases stock issued by a bank is the beneficiary of the extensive regulation of the bank's

---

182. The danger in relying on current statistics is that they change. For this reason, and others, I suggest in Part V that more comprehensive reform of the current system should be considered.

183. See Levitt, *supra* note 145; *Securities Regulatory Equality: Hearings on H.R. 3447 Before the Subcomm. on Telecomm. and Fin. of the Senate Comm. on Energy and Commerce*, 103d Cong. (1994) (statements of Matthew P. Fink, President, Inv. Co. Inst.); *Financial Services Competition Act of 1997: Hearings on H.R. 10 Before the Senate Comm. on Banking and Fin. Servs.*, 105th Cong. (1997) (statements of Denise Voigt Crawford, Tex. Sec. Comm'r, on behalf of the N. Am. Sec. Adm'rs).

184. The Fed may not approve an application by a foreign bank to establish a branch or agency in the United States unless the foreign bank "is subject to comprehensive supervision or regulation on a consolidated basis by the appropriate authorities in its home country." 12 U.S.C. § 3105(d)(2)(A) (1994).

185. See *supra* notes 176-81 and accompanying text.

operations under the banking laws to the extent that such regulation prevents the failure of the bank.<sup>186</sup> The investor in bank stock, however, would not receive the extensive disclosure that is available regarding companies subject to § 5 of the Securities Act.<sup>187</sup>

The securities activities of banks could be regulated under a different scheme than the securities activities of non-banks. This could save banking institutions and taxpayers from the cost of an additional layer of regulation. Other costs, however, may outweigh these savings. For example, under such a system, investors would receive different protections depending on whether they conducted their securities activities with a bank or a non-bank. If we had proof that one system of regulation was better than the other, then the easy answer would be to adopt the "better" regulatory system. In the absence of such evidence, it is perhaps preferable to choose one system over the other for the sake of consistency. Under the current system, because the vast majority of securities activities are regulated under the securities laws, it seems preferable to close the remaining gap. In any event, the carving out of exceptions that are small in real terms does not have the aggregate cost-saving benefits that would be achieved by eliminating entirely an extra layer of regulation.<sup>188</sup>

## 2. Evaluation of Regulatory Division

The issue of regulatory division questions whether Congress was correct in dividing responsibility for administration of the securities laws primarily along institutional lines. This model of dividing regulatory responsibility has the benefit of reducing the number of agencies that are involved in the supervision of any particular bank. This could reduce costs of regulation to the banks<sup>189</sup> and provide the institutional regulator with the opportunity to supervise the full range of bank activities.<sup>190</sup>

---

186. Certainly, many bankers would argue that this hypothetical investor would be better off without the protections provided by the heavy regulation on banks. Without such regulation banks would be better able to compete with their unregulated competitors. This would lead to greater profits and higher stock prices.

187. The bank agencies, however, have adopted some required disclosure under the authority of the banking laws. *See supra* notes 45-46 and accompanying text.

188. For example, although few bank securities are registered under the Exchange Act, *see supra* note 160 and accompanying text, the federal banking regulators, rather than the SEC, are responsible for administering Exchange Act provisions governing those securities. It is likely true that any cost savings to the few banks regulated under these provisions of the Exchange Act are outweighed by the investment by the banking agencies to gain and maintain the expertise to administer those provisions.

189. This model could increase aggregate costs to regulatory agencies, however, insofar as more than one agency has the responsibility for administering, and therefore becoming expert in, the same set of laws.

190. Eugene Ludwig described the appeal of the institutional approach as follows:



The question remains whether the federal banking agencies are effective in administering the securities laws. The banking agencies have been criticized for their sluggish adoption of rules implementing provisions of the Exchange Act.<sup>191</sup> In addition, the banking agencies have been characterized as stealth-like regulators (because of the traditional confidentiality associated with their supervision and enforcement practices)<sup>192</sup> which are unable to administer a disclosure-based regulatory system.

Although legitimate, these concerns may not create a sufficient basis for reform of the current system. First, assuming that the banking agencies are uncomfortable with disclosure based regulation, one answer would be simply that they should improve.<sup>193</sup> In other words, the solution to an agency's inability to administer a particular set of laws does not necessarily lie in transferring that responsibility to another regulator. The solution may be to force the responsible agency to administer the laws as enacted and, if appropriate, provide additional resources. Second, there is recent evidence that banking law and the banking agencies are relying more on disclosure to regulate banking activities.<sup>194</sup> Therefore, the banking agencies may improve their administration of the securities laws concurrent with banks' increased securities activities.

Evaluation of the banking agencies' administration of the federal securities laws could also focus on their enforcement records. Based upon numbers alone, it is possible to conclude that the bank regulators have been lax in their enforcement of the securities laws.<sup>195</sup> The flaw in

A single regulator is in a better position to evaluate risk across product lines, to assess the adequacy of bank capital and operational systems to support all of the activities of the bank, to take integrated supervisory and enforcement actions that address problems affecting several different product lines, and to identify and deal with emerging supervisory issues.

*Securities Regulatory Equality: Hearings on H.R. 3447 Before the Subcomm. on Telecomm. and Fin. of the House of Representatives Comm. on Energy and Commerce*, 103d Cong. 81, 82 (1994) (statement of Eugene A. Ludwig, Comptroller of the Currency).

191. See Malloy, *supra* note 48, at 285-86.

192. See Michael P. Malloy, *Public Disclosure as a Tool of Federal Bank Regulation*, ANN. REV. OF BANKING LAW 229 (1990).

193. See, e.g., Malloy, *supra* note 48, at 295 (urging the banking agencies to improve their administration of the Exchange Act as an alternative to the repeal of § 12(i)).

194. With the passage of the Financial Institutions Reform Recovery Act of 1989, Congress amended the long running practice of confidentiality by requiring cease and desist orders issued by the federal banking regulators to be made public. See 12 U.S.C. § 1818(u) (1994). In 1994, the banking agencies issued a statement on nondeposit investment product retail sales which relies primarily on disclosure to inform customers of risks associated with the purchase of such products. See BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM ET AL., INTERAGENCY STATEMENT ON RETAIL SALES OF NONDEPOSIT INVESTMENT PRODUCTS (1997). See generally Malloy, *supra* note 192, at 235-43.

195. Using the OCC as an example, my research uncovered no actions enforcing the federal securities laws for the first half of 1997 and for 1996. In 1995, the OCC brought enforcement proceedings

this criticism is that its purely quantitative assessment does not take into account the quality of enforcement. For example, depending on the nature of the violations and the violator, one enforcement action could have as much deterrent or prophylactic effect as ten. In addition, the banking agencies would be likely to assert that their low enforcement numbers are simply evidence of their supervisory success. Because the bank regulators are active in supervision, with examinations of most banks every year, they can prevent violations before they occur. Given that they operate in a system with traditional bank supervision as the foundation, they need not rely on the deterrent effect of enforcement as the way to administer the federal securities laws.

The ultimate assessment of the above mixed bag of pros, cons, and uncertainties must also consider the number of regulatees assigned to each institutional regulator. As discussed in Part III, although the administration of the federal securities laws is divided by institution, the actual number of banks engaging in activities that are regulated under those laws is relatively small. Given that the banking agencies' responsibilities under the federal securities laws involve few regulatees, it may be inefficient to require the banking agencies to develop federal securities law expertise, even given the potential benefits of institutional regulation, when that expertise will be used to regulate so few. At the same time, allowing the option for securities law administration by the institutional regulator may provide an outlet for those institutions that deem the prospect of an additional regulator too onerous and, therefore, would choose to conduct their securities activities within the bank itself precisely to achieve the benefits of institutional regulation.<sup>196</sup>

All of the above suggests that it would be difficult to definitively grade the banking agencies' administration of the federal securities laws. It is probably safe to conclude, however, that the banking agencies are administering the securities laws in a manner different from the SEC. This outcome could be viewed as desirable because the tension or competition between the regulators might produce benefits to the system

---

against various employees of Worthen Investment, Inc. for misrepresentations in connection with the sale of mutual funds. See OCC Press Release, *OCC and NASD Announce Settlement of Enforcement Actions Against Employees of Worthen Securities*, NR 95-121 (Nov. 7, 1995). In 1994, the OCC brought five enforcement actions involving securities law violations. See *In re Louis Betanzos*, OCC EA No. 94-82, 1994 OCC Enf. Dec. LEXIS 114 (May 6, 1994); *In re Walter E. Meadley, Jr.*, OCC EA No. 94-87, 1994 OCC Enf. Dec. LEXIS 119 (May 31, 1994); *In re Seattle-First Nat'l Bank*, OCC EA No. 94-103, 1994 OCC Enf. Dec. LEXIS 150 (July 1, 1994); *In re National City Bank of Minneapolis, Minnesota*, OCC EA No. 94-80, 1994 OCC Enf. Dec. LEXIS 112 (April 25, 1994); *In re Chase Manhattan Bank, N.A.*, OCC EA No. 94-158, 1994 OCC Enf. Dec., 1994 WL 652031 (Aug. 26, 1994).

196. This effect would be something closely related to the purported benefits of regulatory competition. See generally Kenneth E. Scott, *The Dual Banking System: A Model of Competition in Regulation*, 30 STAN. L. REV. 1 (1977).

of regulation.<sup>197</sup> Criticism of this inconsistency lies in its effect on consumers. The institutional aspects of the current system result in consumer protection that varies depending on who is the seller of the financial product or the purveyor of the financial service. Clearly, consumers are in no position to be aware of, let alone assess, the relative merits of the different forms of protection.

### 3. Conclusion

The current model of regulating bank securities activities achieves a precarious balance between the benefits of functional and institutional regulation. The investor-protection goals of the federal securities law might be attainable without application of the federal securities laws to the securities activities of banks given the comprehensive and unparalleled regulation of banks and all of their activities. It would not, however, achieve the same investor protection as that provided by the securities laws. Without empirical evidence to support the conclusion that one set of laws provides better investor protection than the other, the federal securities laws should apply to banks' securities activities without exception,<sup>198</sup> providing the benefits of a level playing field to participants in the securities industry and uniform consumer protections. Given the narrow application of the current exemptions, our current system conforms essentially with this aspiration by providing functional regulation on the issue of regulatory breadth. On the other hand, the current system avoids the problems associated with assigning regulatory responsibilities to more than one regulator by relying primarily on the institutional model on the issue of regulatory division. This eases, to a degree, the regulatory burden associated with the overlay of the federal securities laws onto traditional bank regulation.

## V. TOMORROW: REGULATING RISK NOT FUNCTION

The current strength of both our banking industry and securities markets makes a compelling statement regarding the effectiveness of the current system of regulation. Rapid changes in the industry and markets, however, could produce a different assessment in the future. Moreover, continuing calls for reform suggest that industry participants

---

197. See *supra* note 196.

198. I consider the opposite conclusion, that the current federal banking laws should apply to non-bank financial institutions in order to achieve investor-protection goals, to be an interesting possibility but currently outside of the realm of real-world debate. In the future, this may not be as outrageous a proposition. See *infra* notes 235-36 and accompanying text.

are not satisfied with the current system. As a matter of substantive law, reform proposals call for varying degrees of expansion of bank powers into the securities and insurance markets. In this context, reform measures also address questions of regulatory scope and focus primarily on moving the current system towards a more pure system of functional regulation.<sup>199</sup> This is quite understandable because the functional regulation model preserves, to a great extent, agency turf—a distinct political advantage.<sup>200</sup> The preservation of agency turf serves not only the agencies, but also their industry constituents and the congressional committees with jurisdiction over them.

This Part assumes that, either through legislation or continued attempts at liberalization at the agency level,<sup>201</sup> banks will continue to increase their securities activities. This Part concludes that functional regulation will not serve as an effective model for the regulation of future banking activities. Instead, to meet the challenges of the evolving financial marketplace, a model of regulation should focus on the risks that financial regulation seeks to address.

#### *A. Functional Regulation Will Not Endure*

To the extent that proposed legislation would eliminate current bank exemptions under the federal securities laws,<sup>202</sup> such proposals offer an incremental improvement over our current system. Still, the fundamental problem with the current system and proposals for reform is reliance upon the functional regulatory model, which is based on the notion that regulation and regulatory responsibility can and should be separated along functional, or product, lines. That notion is flawed.

First, the division of regulation along functional or product lines suggests that different products represent distinct regulatory issues.

---

199. In the first session of the 105th Congress, three bills were introduced addressing financial modernization: H.R. 10, H.R. 268, and H.R. 669/S. 298. All three bills provided for purer functional regulation of banks' securities activities than under our current system although in different ways. For example, H.R. 669/S. 298 provided for functional regulation by prohibiting banks that are owned by a financial services holding company from engaging in many securities activities. In contrast, H.R. 10 provided for functional regulation by removing, for the most part, the current exemption for banks from the definition of "broker" and "dealers," thus providing for regulation of those activities under the securities laws by the SEC. The Treasury Department has also drafted a plan for financial modernization that includes functional regulation reform provisions. See Financial Services Competition Act of 1997 (visited June 6, 1997) <<http://www.ustreas.gov/treasury/financial/domfin/fsca/>>.

200. Because the current system is drawn largely along functional lines, especially when considering the low level of securities activities conducted at the bank level, reform that aspires only to a purer form of functional regulation does not entail great gains or losses for any of the federal regulators.

201. See *supra* Part I.

202. See *supra* Part II.

They do not. A bank's FDIC insured deposits raise a host of regulatory issues including potential loss to the bank insurance fund (if the bank fails), fraud on depositors (if the bank lies), and potential disruptions to our financial system (if the bank is big, and fails). A bank's brokerage accounts raise a host of regulatory issues that do not include losses to the bank insurance fund, but do include fraud on investors (if the bank lies) and potential disruptions to our financial system (if the bank is big, and fails). Put in broader terms, the banking agencies' safety and soundness concerns are not contained within the traditional bank activities of lending and deposit taking. To determine the safety and soundness of a bank, the banking agencies must consider all of the bank's risk-taking activities.<sup>203</sup>

Second, the functional regulation model assumes incorrectly that financial products may be divided and conquered under different regulatory schemes and by different agencies. This may have been true when a bank deposit was a bank deposit and a stock was a stock. Yet, if recent history is any indication of market trends, the blending of traditional financial products will continue. Consider that today, it is difficult to distinguish the regulatory concerns which arise from a mutual fund account that provides check writing privileges from an insured bank deposit. There is no FDIC insurance for the mutual fund, so there is no risk to the bank insurance fund. Checks drawn on the mutual fund account, however, impact the payment system,<sup>204</sup> a traditional bank regulatory concern. The account raises investor protection concerns, a traditional securities regulatory concern.

Last, the functional model lacks the flexibility to facilitate, or even accommodate, evolutions in the substantive regulation of the banking and the securities industry. It is an oversimplification to say that our current substantive regulation of the banking and securities industry is a matter, exclusively and respectively, of safety and soundness and investor protection. The securities laws provide for safety and soundness, and the banking laws provide for investor protection. Functional regulation, however, tends to work best when regulatory goals can be divided neatly along product lines.<sup>205</sup> Again, if history is

---

203. For example, the OCC rules provide that the failure to comply with its securities offering disclosure rules (the OCC's parallel to Securities Act registration) constitutes an unsafe or unsound banking practice. See 12 C.F.R. § 16.32(c) (1994). Although a bank's conduct with regard to the issuance of its own shares would not be characterized as a traditional banking activity, it is one that the OCC deems important to the bank's overall safety and soundness.

204. For a description of the payment system, see *infra* note 225.

205. As discussed *supra* note 204 and accompanying text, traditional banking and securities products raise many and, sometimes overlapping, regulatory issues.

any indication of the future, it is likely that the traditional banking and securities regulatory regimes will become more similar over time.<sup>206</sup>

Mutual fund assets have tripled since 1990, to \$3.2 trillion in 1996, easily outstripping the \$2.6 trillion held in insured commercial bank deposits.<sup>207</sup> Much of the recent mutual fund growth is attributed to individual retirement savings.<sup>208</sup> Imagine the impact of the first major mutual fund failure on our current system of regulation.<sup>209</sup> Will investors, regulators, and lawmakers be satisfied with a system of disclosure based regulation in the face of significant losses? In an era of government downsizing, it is difficult to imagine that Congress would move, in such an event, to adopt a system of federal insurance for mutual fund deposits as it did in the face of the massive bank failures of the 1930s.<sup>210</sup> Congress might, however, seek to impose greater safety and soundness controls on the mutual fund industry.<sup>211</sup>

Alternatively, consider the future of bank regulation if disintermediation continues. If dollars continue to move out of insured deposits and into other financial vehicles, our costly system of regulating banks, and the deposit insurance program, may no longer be justified.<sup>212</sup>

For similar reasons, institutional regulation is not a viable alternative for the future. Institutional regulation relies on the premise that different entities present distinct regulatory issues. This is not the case.

---

206. See *infra* notes 209-12 and accompanying text.

207. See GAO, *Mutual Funds*, *supra* note 3, at 3.

208. See *id.*

209. Of course, mutual funds do not suffer from the risk of runs that banks do principally because of the liquidity of their assets. See JONATHAN R. MACEY & GEOFFREY P. MILLER, *BANKING LAW AND REGULATION* 55 (2d ed. 1997). Still, it is possible for a mutual fund to fail, particularly in the event of misappropriation of assets or the like.

210. The industry, however, is showing signs of moving in that direction. Fidelity Investments and Marsh & McLennan have both announced plans to offer shareholder insurance against loss due to default on their money market mutual funds. M.B. Hart, *Fidelity Debuts Money Market Fund Insurance Plan*, *FUND DIRECTIONS*, Sept. 1996, at 1, 1.

211. In fact, one of the criticisms of some models of financial modernization is that relying on the bank holding company structure for the expansion of banks' securities activities has the effect of imposing safety and soundness regulation on non-banks. See Mark B. Sutton, Executive Vice President, Pain Webber Group, Inc., Before the House Subcommittee on Finance and Hazardous Materials Financial Services Restructuring (May 1, 1997).

212. Although there is little current support for the complete elimination of federal deposit insurance, proposals for reform of the structure are common. See generally R. Mark Williamson, *Regulatory Theory and Deposit Insurance Reform*, 42 CLEV. ST. L. REV. 105 (1994) (discussing and categorizing various theories of deposit insurance reform). Congressman Tom Petri and bank consultant Bert Ely have structured a system of cross guarantees that would eliminate federal deposit insurance. See Tom Petri & Bert Ely, *Better Banking for America: The 100 Percent Cross-Guarantee Solution*, COMMON SENSE: A REPUBLICAN JOURNAL OF FACT AND OPINION, Fall 1995; see also H.R. 4318, 104th Cong. (1996) (bill introduced by Congressman Petri to implement the cross-guarantee approach). Even in the unlikely event that federal deposit insurance was eliminated, banks would be subject to some other form of insolvency regulation. See *infra* notes 232-36 and accompanying text.

Even without liberalization of bank powers, a banking entity can engage in activities that raise insurance fund issues (through its insured deposits) and investor protection concerns (through its brokerage activities), just as an individual activity can raise more than one regulatory concern.<sup>213</sup>

*B. Regulating Financial Risk: A Flexible, Focused Alternative*

An approach better suited to the future of the banking industry must focus directly on the risks that financial regulation was developed to address. The goal of bank regulation is linked traditionally with the safety and soundness of banking institutions. The goal of bank regulation, however, can be more particularly and, perhaps, more accurately,<sup>214</sup> defined as two-fold:<sup>215</sup> the protection of the bank insurance fund<sup>216</sup> and the protection of the financial system. Safety and soundness is a means towards the end of stemming the risk to the bank insurance fund and systemic risk.

Similarly, although the goal of the regulation of our securities industry and markets is often couched in terms of investor protection, it can also be viewed as a system that seeks to control the risk of fraud and abuse in financial markets.<sup>217</sup> To the extent that "disclosure" is often used as an icon for securities regulation, clearly, disclosure is only a means for preventing fraud and abuse.

Focusing on these risks, rather than the means to address them, provides a stronger foundation for an enduring regulatory regime. Because the risks that our system seeks to regulate are not likely to vary

---

213. See *supra* note 204 and accompanying text.

214. "Safety and soundness" as a label for the goal of bank regulation is perhaps misleading because it suggests that the goal of bank regulation is to protect the solvency of individual banks. Although the prevention of individual bank failure may be important for the protection of depositors, federal deposit insurance addresses that concern. Therefore, our banking laws seek to protect against the risk of failure of an individual bank only in cases where that bank's failure presents a systemic risk. For example, the only exception to the requirement that the FDIC apply the "least cost test" to decisions regarding the resolution of insolvent institutions involves cases in which the insolvency would have systemic implications. See *supra* note 172.

215. To a lesser degree, but importantly, bank regulation has also addressed the risk of unfairness to bank customers. For a general discussion of the goals of bank oversight, see generally GAO, *GAO Bank Oversight Structure: U.S. and Foreign Experience May Offer Lessons for Modernizing U.S. Structure*, GAO/IGD-97-23, at 28 (Nov. 1996).

216. The protection of the bank insurance fund is one of the primary goals of bank regulation because Congress has chosen to address the special risks associated with banking through the provision of federally guaranteed deposit insurance. See discussion *infra* notes 232-36 and accompanying text.

217. It is, I believe, more accurate to define the goal of securities regulation in terms of fraud and abuse as opposed to investor protection because our substantive regulation has not always sought to "protect" investors. Rather, our system has sometimes operated in a protective mode (e.g., by prohibiting the sale of certain securities to non-accredited investors) and more often sought to provide a means for consumers to protect themselves (e.g., by providing disclosure).

over time,<sup>218</sup> a regulatory model built around those risks can better withstand the mutation of financial products and changes in the character of financial organizations that are common today. The means by which we address financial risks (i.e., our substantive laws) will and should change.<sup>219</sup> A regulatory model built around risk not only anticipates changes in the marketplace, but can better accommodate changes in substantive laws than our current model or pending reform measures.

In sum, banks' securities activities conjure the following regulatory risks: failure of the bank insurance fund, disruption of financial market stability (including breakdown of the payment system), and unfairness towards consumers (fraud and abuse). Consideration of these risks helps address the questions of regulatory breadth, i.e., how far should our laws reach, and regulatory division, i.e., what agency should be responsible for administering the laws.<sup>220</sup>

### 1. Regulatory Breadth

The debate over regulatory models usually centers on the question of regulatory division.<sup>221</sup> Yet, regulatory breadth, which focuses on the substance of the laws regulating finance, is more vital to the ongoing effectiveness of the regulatory regime. With banks' securities and traditional activities as the primary focus, this subpart begins by examining how our finance laws could be reformed under the risk based model and identifies the fundamental challenges to such reform. This subpart then considers, separately, each of the financial risks to be regulated—insurance fund risk, systemic risk, and unfairness risk—and profiles some of the particular challenges and innovations posed by regulating those risks under the proposed model.

Traditionally, the debate concerning regulatory breadth has focused on whether the federal securities laws should apply to banks' securities activities in the same manner in which they apply to non-bank financial firms.<sup>222</sup> Under the functional approach, the answer was "yes." Under

---

218. Certainly the privatization of deposit insurance would eliminate the bank insurance fund risk. See discussion *supra* notes 232-36 and accompanying text.

219. The growing use of the Internet for financial transactions may lead to more and more transfers of wealth outside of our bank-based payment system. The regulatory risk will remain the same, but regulation will have to venture beyond the banking channels that once contained that risk.

220. For discussion of similar proposals that focus on a "goals-oriented" approach to financial regulation, see Ely, *supra* note 124; Wallman, *supra* note 124; Michael Taylor, "Twin Peaks": A Regulatory Structure for the New Century, CENTRE FOR THE STUDY OF FINANCIAL INNOVATION, Dec. 1995.

221. This is not surprising because the question of division determines regulatory power.

222. See *supra* Part III.B.1.



the risk based model of regulation, both the question and the answer are different fundamentally. Under the risk based approach, legislators must identify first what risk the substantive law in question seeks to address. If the answer is the risk of fraud and abuse (true, for most provisions of the federal securities laws), then the question becomes whether those laws need the breadth to cover banks' activities in order to stem the risk of fraud and abuse. Therefore, if banks engage in activities that involve the kind of fraud and abuse regulated under the securities laws, those activities should be covered by the securities laws. Similarly, if the substantive law in question seeks to protect the bank insurance fund (as with most of the federal banking laws), the law must be given the scope to control that risk. Therefore, if the activities of a bank affiliate could cause a loss to the bank insurance fund, the laws enacted to protect the fund must reach that activity, or impose the necessary firewalls or other protections to ensure that those activities do not create that risk.<sup>223</sup>

Although this analysis might appear to provide no more than a different route to the same result reached under the functional regulation model (i.e., application of the federal securities laws to banks' securities activities and application of the banking laws to activities affecting safety and soundness), a more particular analysis of the question of regulatory breadth under the risk based model reveals important differences from the functional model and challenges to our substantive laws. The difference is that, under a risk based model, the breadth of regulation is not determined by a classification of an activity as a *securities* activity or a *banking* activity, or a determination of whether the activity is conducted by a *bank* or a *securities firm*. Most of our laws addressing financial risk are product- and entity-centric, drawing on the functional and institutional models.<sup>224</sup> Reforming laws so that they address current and future risks requires foresight and, perhaps, heavy reliance on administrative rulemaking to establish regulatory parameters. We often see a lag in regulation when compared to the

---

223. The risk based model of regulation does not necessarily provide a neat answer to the debate over whether securities activities must be housed in a bank affiliate as opposed to the bank itself or a bank subsidiary. This controversy typically pits the OCC (regulator of national banks and their subsidiaries) against the Fed (regulator of bank affiliates and bank holding companies). See *supra* note 132 and accompanying text. The model does suggest, however, that this issue revolves around the risk to be regulated and the means necessary to contain those risks rather than the division of power between agencies.

224. For example, the provisions of the Exchange Act hinge almost exclusively on the existence of a transaction in a "security." Therefore, the regulatory protections under the Exchange Act are largely lost when dealing with financial products other than securities. This is a functional approach to the drafting of substantive law.

products and services offered by our financial industry. This occurs because our regulatory structure has generally been reactive to market events, thus focusing on existing products and activities. Our regulatory scheme is not proactive or centered on the risk to be regulated. For example, the current regulation of our payment systems<sup>225</sup> is implemented through the regulation of banks. This made sense historically because banks had control over the payment system.<sup>226</sup> With the development of stored-value cards<sup>227</sup> (issued by banks and non-banks) and other forms of electronic cash,<sup>228</sup> transfers of value occur today outside of the bank-based payment system. Not only does this mean that regulated banks are now competing with unregulated non-banks in the market for these new products, but that these products, when offered by non-banks, are not subject to regulation.<sup>229</sup> If our laws addressed the risk to the payment system, rather than the entities maintaining the system or products traditionally used in the system, drastic reform would not be necessary in the face of continuing and increasing technological advances.<sup>230</sup>

A risk based system of financial regulation would allow sufficient flexibility to address changes in products and realignment of entities. Yet, such flexibility creates a major challenge in terms of drawing the appropriate boundaries of financial regulation. By eliminating the

---

225. The GAO described recently the term "payment system" as follows:

The general term payment system refers to a mechanism for the transfer of monetary value and related information. Transfer of value can occur, for example, when a customer writes a check to a company and the funds are then transferred from the customer's bank account to the bank account of the company. Related information exchanged at the same time might include the identification of the payee and the payor, bank account numbers, and the date of payment.

GAO, *Payments, Clearance, and Settlement: A Guide to the Systems, Risks, and Issues*, GAO/GGD-97-73, at 2 (June 1997).

226. Payment by check still accounts for the largest volume of noncash payments in this country. *See id.* at 93.

227. A stored-value card is a device that resembles a credit card, containing a magnetic strip or a computer chip which stores information (those with computer chips are often referred to as "smart cards"). Electronic cash is stored on the stored-value card (the electronic cash is purchased with currency). A holder of the stored-value card can use the card to make purchases from vendors willing to accept the electronic cash as a form of payment. For the FDIC's position on whether stored-value cards may be considered insured deposits, see *Stored Value Cards*, 61 Fed. Reg. 40,490 (FDIC 1996).

228. Electronic cash can also be stored on the hard drive of a computer.

229. *See generally* Michael A. Fixler, Note, *CyberFinance: Regulating Banking on the Internet*, 47 CASE W. RES. L. REV. 81 (1996). State laws, however, may apply to the non-bank issuers as well. *See id.* at 161; GAO, *Payments, Clearance, and Settlement*, *supra* note 225, at 161.

230. Alternatively, the risk to the payment system could be contained, for example, by prohibiting non-banks from issuing electronic forms of cash. This alternative is viewed by many as stifling unnecessarily competition. *See* U.S. TREASURY, AN INTRODUCTION TO ELECTRONIC MONEY ISSUES, 71 (1996) (prepared for the U.S. Department of the Treasury Conference, *Toward Electronic Money and Banking: The Role of Government*).

current product- or entity-centric boundaries of our financial regulation, other borders must be drawn. Refining the definition of the risk to be regulated assists in creating workable boundaries. Our current system of financial regulation employs, to a degree, this method of line drawing. For example, under the federal securities laws, certain sophisticated investors receive fewer protections than less sophisticated ones. One way to rationalize this distinction is to conclude, as a policy matter, that certain investors do not need, or perhaps merit, protection from the risk of fraud and abuse. Arguably, this merely replaces product- or entity-based regulation with customer- or investor-based regulation. Certainly, if this method of refining the risk to be regulated were taken too far, our financial regulation could be so driven by customer definition as to create some of the same anachronisms that plague our current system.<sup>231</sup> Still, some amount of refining of risk on customer lines may avoid overreaching and the certain obsolescence of the boundaries drawn on the current product or entity lines.

More specifically, consideration of each of the three financial risks identified above poses challenges to the substantive law that currently seeks to regulate those risks. The bank insurance fund risk exists only because Congress chose to address the particular risks faced by bank depositors primarily through the creation of the federally guaranteed bank insurance fund.<sup>232</sup> Elimination of FDIC insurance seems politically improbable and, perhaps, undesirable, but fundamental reform of the system has received scholarly and industry support.<sup>233</sup> If federally guaranteed insurance is eliminated, the bank insurance fund risk is eliminated. Under our current model of regulation, the elimination of bank insurance fund risk might lead to alternative regulation of the risk of bank insolvency.<sup>234</sup> Yet, as compared to the other regulatory risk identified, this risk is entity specific, that is, the risk

---

231. For example, in the same way that the development of new products eludes regulation drawn on product lines, the development of new vehicles for delivery of products to customers could elude regulation drawn on customer lines.

232. As described by Professor Swire, prior to the creation of deposit insurance, "a bank failure posed two sorts of threats to the local or national economy. First, depositors would lose access to their transaction accounts—their checks would not clear, and they would in general lose the key benefit of 'immediacy,' or immediate access to their money." Peter P. Swire, *Bank Insolvency Law Now That It Matters Again*, 42 DUKE L.J. 469, 490 (1992).

233. See *supra* note 212 and accompanying text. Notably, Canada, France, Germany, Japan and the U.K. do not explicitly provide federally guaranteed deposit insurance. See GAO, *Bank Oversight Structure*, *supra* note 215, at 67.

234. The elimination of FDIC insurance, however, would likely lead to the creation of private insurance schemes. In that event, the government would certainly have in role in regulating private insurers (which may include banks acting as self-insurers or insurers of other banks). See *supra* note 212 (citing a proposal for the elimination of federal deposit insurance and the creation of a cross-guarantee system).

of bank failure. Historically, bank failure risk was a key regulatory concern because banks, by their nature, were more susceptible to failure. In the future, banks may not hold a special risk of insolvency as they diversify (assuming continued expansion of bank powers) and as demand deposits decline as a percentage of their liabilities (assuming continued disintermediation). If we view the banks of the future as firms that are consolidated with securities and possibly other commercial firms, they may not merit special regulatory treatment. At the same time, the regulation of insolvency risk may be extended, to a degree, to the consolidated financial services firm. This outcome becomes more probable as more and more "small savers" invest their money in nondeposit financial products.<sup>235</sup> In sum, the regulation of insolvency risk in the future may contract vis-à-vis bank-specific regulation and expand vis-à-vis overall financial services wherein all financial services firms will be subject to some, and the same, insolvency-risk regulation.<sup>236</sup>

Turning to the refinement of the systemic risk to be regulated, attention must be given to the globalization of our financial markets. Particularly given the growth in technology, the integrity of our financial system can no longer be ensured within our borders. Reforming our substantive laws to more directly and effectively regulate our payment system, for example, will require international cooperation and coordination. We cannot rely on the unilateral enforcement of domestic laws to contain the systemic risk in a global financial marketplace.

Finally, refining the risk of unfairness highlights some of the public policy choices made under our current substantive laws. For example, the Community Reinvestment Act (CRA)<sup>237</sup> offers an example of an entity based law that seeks to address the unfairness associated with the failure to provide credit services to low income neighborhoods.<sup>238</sup> The CRA mandates that the federal banking regulators encourage depository institutions "to help meet the credit needs of the local communities in which they are chartered consistent with the safe and sound operation of such institutions."<sup>239</sup> To the extent that the CRA addresses lack of access to credit (as opposed to access to insured deposits), it is not obvious why the law is entity-centric. The risk based

---

235. See *supra* notes 209-11 and accompanying text (discussing the potential regulatory consequences of the first major mutual fund failure).

236. Michael Taylor's "Twin Peaks" proposals for the reform of the U.K.'s system for regulating financial services combines protection of depositors, investors, and policy-holders into the consumer protection peak of the model. See Taylor, *supra* note 220.

237. See 12 U.S.C. §§ 2901-2907 (1994).

238. See generally Jonathan R. Macey & Geoffrey P. Miller, *The Community Reinvestment Act: An Economic Analysis*, 79 VA. L. REV. 291, 298-99 (1993).

239. 12 U.S.C. § 2901(b) (1994).

focus suggests a broadening of the scope of the CRA to all lenders, not just depository institutions.<sup>240</sup> This illustrates how a risk based approach to regulatory breadth effectively advances regulatory goals.

## 2. Regulatory Division

While the parameters of substantive law are important to the ultimate regulation of financial risk, those laws must be administered under an appropriate regulatory structure. Using banks' securities and traditional activities as the focus, this subpart outlines how regulatory responsibility would be best divided under the risk model. This subpart first addresses that issue in theory, and then suggests how regulatory responsibility would be divided in reality and in an attempt to preserve as much of the current regulatory expertise and organizational structure as possible.

In the abstract, the issue of regulatory division is simple under the risk model. Once the financial risks have been identified and the substantive laws have been given the appropriate breadth to address those risks, regulatory responsibility can be divided according to the risk regulated. Thus, Congress would assign one agency responsibility for administering laws that address risk to the insurance fund, one for the laws that target systemic risk, and one for the laws governing the risk of unfairness.

The main challenge to this division of regulatory responsibility is that it creates a degree of agency overlap, although less than under our current system.<sup>241</sup> A major fraud involving a large bank's securities activities could put the bank insurance fund, the financial system, and fairness at risk. Under this system, therefore, all three agencies would bear responsibility for preventing major fraud.<sup>242</sup> This outcome is not necessarily undesirable, because each agency would bring its experience and its distinct regulatory goal to the task. For example, the systemic risk regulator would address the issue of major fraud differently from the bank insurance fund risk regulator.<sup>243</sup>

---

240. Eugene A. Ludwig, Comptroller of the Currency, recently proposed whether CRA-like requirements should be imposed on non-bank financial institutions. See Eugene A. Ludwig, Comptroller of the Currency, Remarks Before the Director's Roundtable in San Francisco, California, NR 97-65 (July 15, 1997). For a general discussion of the discriminatory impact of the Community Reinvestment Act (CRA) on depository institutions, see Macey & Miller, *supra* note 238, at 312-18.

241. See *infra* note 246-53 and accompanying text.

242. Under our current system, at least four agencies (the OCC, the Fed, the FDIC, and the SEC) would be involved, assuming that this hypothetical bank is a national bank conducting its securities activities through an affiliate.

243. The difficulty arising from the regulatory overlap which exists under our current system of regulation is that not only do the respective jurisdictions of the regulators overlap, but each regulator is serving, to a degree, the same goals—the securities regulator is attempting to provide for investor protection as well as financial system stability and so are the banking regulators. Goal redundancy would not be at

Combining one or more of the three agencies into a super-regulator could eliminate agency overlap. Proposals for super-regulators, however, have been viewed with skepticism.<sup>244</sup> The super-regulator approach has been criticized because the combination of regulatory responsibility for different goals might obscure the agencies' mission, making it less efficient and effective.<sup>245</sup> Moreover, the concentration of regulatory power may be undesirable simply because it vests so much power in one agency. For better or worse, banks have long influenced regulation by playing one regulator off the other (state versus federal, federal versus federal). The super-regulator approach would likely transform the dance between banks and their regulators into a march with the super-regulator at the lead. Finally, the super-regulator approach might be dismissed on the basis of the disruption it would cause to the current regulatory culture. Although this Article suggests that the preservation of agency turf should not drive reform of our current model of regulation, it does not advocate razing the existing regulatory community. Rather, it suggests that a model for reform should take advantage of existing expertise when dividing regulatory responsibility.

The risk model of regulation could be implemented by redrawing regulatory responsibilities among existing agencies as follows.<sup>246</sup> The risk to the bank insurance fund is sensibly assigned to the FDIC. The FDIC possesses the expertise to perform this function because it is the primary regulator for state non-member banks. This would expand considerably the FDIC's jurisdiction, making it the primary federal regulator (on bank insurance fund risk) for all banks offering FDIC insured deposits.<sup>247</sup> The FDIC would be responsible for administering laws that relate to banks' safety and soundness because this is the fundamental means of protecting the bank insurance fund under our current system.<sup>248</sup>

---

issue in the risk model.

244. The U.K.'s recent proposal to strip the Bank of England of its supervisory powers and vest such authority with the Securities and Investments Board, which would have supervisory responsibility for banking, securities, and insurance, has been the center of much debate and criticism. *See Does the UK Experiment Make Sense?*, THE FINANCIAL TIMES (June 1997); Michael Taylor, *Super-SIB Concept Too Complex and Over-concentrates Power*, THE FINANCIAL TIMES (June 4, 1997); Charles Goodhart & David Llewellyn, *A Blurred Outlook*, THE FINANCIAL TIMES (May 30, 1997).

245. This criticism has been made regarding the U.K.'s proposed super-regulator. *See* Goodhart & Llewellyn, *supra* note 244.

246. This Article does not seek to advocate the assignment of responsibilities to, or removal of power from, any particular existing agency. The following serves only as an example of how the model could be implemented with, perhaps, the least disruption to the current system.

247. This would remove safety and soundness responsibility from the Fed, the OCC, and the OTS.

248. *See supra* note 170 and accompanying text.

In the spirit of preserving the current organizational structure, the Fed would become the systemic risk regulator under the risk model because the Fed currently bears the primary responsibility for systemic risk. The responsibility for systemic risk, however, need not be assigned to the central bank (the entity responsible for monetary policy). Moreover, the Fed's role as the largest purveyor of payment services creates a conflict of interest with its role as regulator of payment systems.<sup>249</sup> Such designation, however, provides the Fed with access and understanding which should assist with the implementation of monetary policy. Under the risk model, the Fed would not only retain its systemic risk responsibilities, but would also gain responsibility for regulating transfer and clearing functions, currently regulated by the SEC and the bank regulators. This redesignation would give the Fed more comprehensive control over activities that pose a threat to the stability of our financial markets.

The SEC, predictably, would be responsible for administering laws that address the risk of unfairness in financial markets. This preserves the SEC's fundamental function under the securities laws. In addition, the SEC would acquire responsibility for consumer protection laws currently administered by the bank regulators such as Truth In Savings,<sup>250</sup> the CRA,<sup>251</sup> and the Equal Credit Opportunity Act,<sup>252</sup> to name a few.

This division leaves the OCC and OTS without responsibilities other than the chartering of national banks and national savings associations, respectively. The FDIC could be given the authority to grant national bank and savings associations charters.<sup>253</sup> Alternatively, the federal bank and savings association charter could be abandoned.

The OCC and the OTS reside within the Department of Treasury (Treasury). This proposal, therefore, eliminates Treasury's role in bank supervision. Treasury's ability to formulate economic policy might suffer without some access to bank supervision. To alleviate this

---

249. See GAO, *Payments, Clearance, and Settlement*, *supra* note 225, at 168.

250. See 12 U.S.C. §§ 4301-4313 (1994).

251. See *id.* §§ 2901-2907.

252. See 15 U.S.C. § 1691 (1994).

253. Designating the FDIC as the federal chartering authority has efficiency benefits to the extent that the FDIC already must evaluate a new institution for its eligibility for FDIC insurance. Currently, separate application must be made to the FDIC in order to become an insured depository institution. See 12 U.S.C. § 1815(a)(1). In granting a national bank charter, however, the OCC must also certify to the FDIC that it has considered the same factors as those considered by the FDIC in granting deposit insurance. See *id.* §§ 1814(b). The same is true regarding the Fed's decision to grant membership to a state-chartered bank, i.e., the Fed must certify to the FDIC that it has considered the same factors as those considered by the FDIC in granting deposit insurance. See *id.*

concern, Treasury could maintain its seat on the Board of Directors of the FDIC.

In sum, the realignment of regulatory responsibility under the risk model involves only one major institutional change—the elimination of the federal chartering authorities. Otherwise, the model can be implemented by maintaining the fundamental responsibilities of existing agencies (the FDIC, the Fed, and the SEC) and reassigning the more ancillary ones.

## VI. CONCLUSION

The current paradigm of regulation of bank securities activities—the functional equivalent of functional regulation—is an acceptable form of regulation given the status quo. Current legislative proposals for reform will not alter the current system to any notable extent. Our financial marketplace is changing, however, and the current regime is not suited to address such changes. Real reform—with a view to the future—will require something more fundamental.

Divining the scope of financial regulation by the risk to be regulated, rather than the entity or product providing a financial service, provides greater flexibility in achieving regulatory goals in an environment in which the character of entities and products continues to evolve. Defining the breadth of regulation according to the risk to be regulated allows for laws that are not made obsolete by market innovation. It also provides for substantive laws more faithful to their ultimate goal (that is, the abatement of a particular financial risk). Dividing regulatory responsibility according to regulated risk leads to overlapping agency jurisdiction (over products and activities), but not task (one financial risk assigned to each). Agencies are assigned to one risk and given full authority and responsibility for regulating that risk. Undue concentration of agency power, and unnecessary disruption to our current system, is avoided by dividing regulatory responsibility along existing lines of expertise. At the same time, the number of federal agencies responsible for financial risk is reduced—a significant factor in an era of government reinvention.

Regulating risk, not function, would better prepare our system of financial regulation for the consolidated, international, and computerized financial institutions of the twenty-first century. The risk model, however, may suffer from a lack of political appeal. Because the model entails at least some losses of authority for each of the financial



regulators,<sup>254</sup> it may not satisfy the survival instincts of existing agencies. Because the model calls for proactive substantive laws, it may threaten members of an industry accustomed to reactive legislation. Similarly, lawmakers confronted with an antiquated system of congressional committee jurisdiction will perceive implementation of a risk based model as a daunting task. Our lawmakers, therefore, must overcome significant hurdles to chose reform that will outlast this century and endure well into the next. The risk model can provide the foundation for such reform.

---

254. The Fed might possibly perceive the risk based model as providing it with increased, or at least equal, regulatory power to the extent that the model puts the Fed in charge of all systemic risk issues. Of course, the Fed would lose its supervisory power over state member banks and bank holding companies to the extent no systemic issues are involved. In addition, the risk model does not necessarily provide for the placement of systemic risk responsibility with the central bank. See *infra* note 249 and accompanying text. In this case, implementation of the model could include a decision to transfer the Fed's responsibility for monetary policy to a different regulatory body.