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An International Perspective on Domestic Banking Reform: Could the European Union's Second Banking Directive Revolutionize the Way the United States Regulates its Own Financial Services Industry?

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**AN INTERNATIONAL PERSPECTIVE ON
DOMESTIC BANKING REFORM:
COULD THE EUROPEAN UNION’S SECOND
BANKING DIRECTIVE REVOLUTIONIZE THE
WAY THE UNITED STATES REGULATES ITS
OWN FINANCIAL SERVICES INDUSTRY?**

JENNIFER MANVELL JEANNOT*

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INTRODUCTION

The banking industry is one of the most heavily regulated industries in the United States.¹ Some of the banking regulations have resulted merely from historical circumstance,² while others have been

1. See generally JONATHAN R. MACEY & GEOFFREY P. MILLER, *BANKING LAW AND REGULATION* 73 (2d ed. 1997) (discussing the American banking system extensively); ALFRED LEWIS & GIOIA PESCIETTO, *EU AND US BANKING IN THE 1990S* 72 (1996) (providing an overview of the current regulation of the banking industries in the European Union and the United States).

2. See MACEY & MILLER, *supra* note 1, at 2 (stating that few areas of American law are influenced more significantly by history than banking law and purporting that much of the quirkiness of banking laws can be understood only through historical analysis); see also Richard M. Whiting, *The New Tri-Partite' Banking System*, 17 *BANKING POL'Y REP.*, Apr. 16, 1998, at 13 (1998) (explaining that the United States' current dual banking system, which provides the option of obtaining a federal or a state charter, was an unintended result of Congress' crea-

designed to attain specific policy objectives.³ Notwithstanding an intricate regulatory structure, recent marketplace developments⁴ and administrative initiatives⁵ demonstrate that the current regulatory framework for the domestic financial services⁶ industry is now outmoded.⁷ Moreover, the globalization of international markets⁸ and the

tion of the national bank charter in 1863). The dual banking system, in turn, has unexpectedly fostered the development of many innovative financial products, such as the interest-bearing checking account. *See id.*

3. *See* S. REP. NO. 73-455, at 1 (1934) (justifying the passage of the Glass Steagall Act of 1933, which restricts the ability of commercial banks to engage in certain securities transactions, as a means to prevent further abuses by banks in the securities industry). The abuses at issue concerned action occurring in the 1920s that allegedly led to the stock market crash of 1929 and the subsequent banking crisis of the early 1930s. *See id.* at 1-2; *see also* LEWIS & PESCIOTTO, *supra* note 1, at 74 (indicating that certain provisions of the Glass Steagall Act, such as those that separate commercial from investment banking, were intended to circumscribe the free banking of the 1920s and to return bankers to their original conservative service roles).

4. *See Future of Banking: Financial Modernization Is Occurring Apace Without New Legislation*, BANKING POL'Y REP., July 1, 1996, at 12 (emphasizing that true financial modernization has already occurred in the marketplace and that the industry will continue to evolve and pose new issues for bankers, policymakers, and regulators). As a result, legislators redrafting the financial service laws must base those new laws on principles that respect, rather than combat, the market forces that are currently redefining the banking industry. *See id.*

5. *See, e.g., Developments in Banking Law: 1997*, 17 ANN. REV. BANKING L. 2, 6-7 (1998) (explaining that although Congressional attempts to reform the banking industry in 1997 failed, the Federal Reserve has taken administrative action to liberalize the rules governing banks and their affiliates). For example, in 1987, the Federal Reserve Board permitted bank holding companies to create securities underwriting affiliates under section 20 of the Glass Steagall Act. *See id.* at 6. The Federal Reserve Board has also continued to raise the percentage limit of gross revenues that can be generated from such bank-ineligible securities by bank holding companies. *See id.* at 6-7.

6. *See* ANTHONY SAUNDERS & INGO WALTER, *UNIVERSAL BANKING IN THE UNITED STATES: WHAT COULD WE GAIN? WHAT COULD WE LOSE?* 5 (1994) (defining financial services, generally, as including activities such as: deposit taking; lending; underwriting and distributing new issues of debt and equity securities; securities trading and brokerage; investment management; fee-based advisory activities; insurance; foreign exchange transactions; and derivative instruments, such as futures and options).

7. *See* Robert M. Kurucz & Barry I. Pershkov, *Securities and Investment*

deregulation of banking services in industrialized countries⁹ have significantly affected the competitive posture of American financial institutions and have potentially placed the domestic banking industry at a competitive disadvantage.¹⁰

Over the past several years, Congress has, to no avail, attempted to liberalize domestic banking regulations.¹¹ While the many parties implicated by such reform¹² agree that the current financial system

Activities of Banks, 53 BUS. LAW. 1145, 1154 (1998) (concluding that the increasing importance of securities and investment activities to commercial banks demonstrates that the Glass Steagall Act is an anachronistic law, largely outdated by regulatory action and marketplace developments).

8. See *Financial Modernization-Part II: Hearings Before the House Comm. on Banking and Fin. Servs.*, 105th Cong., 405, 407 (1997) (statement of Eugene A. Ludwig, former Comptroller of the Currency) [hereinafter *Hearings: Statement of Eugene Ludwig*] (postulating that technological innovation has fueled economic globalization, which, in turn, has increased competition in the financial services market).

9. See OFFICE OF THE COMPTROLLER OF THE CURRENCY NEWS RELEASE, OCC NR 97-34, at 1 (Mar. 24, 1997) (concluding that the United States was a notable exception in the study of sixteen European countries, as well as Canada and Japan, which found that almost all of those countries permit their banks directly or indirectly through subsidiaries to engage in a wide range of financial services, such as underwriting, dealing, and brokering in securities and insurance).

10. See *id.* at 2 (reporting that the former Comptroller of the Currency, Eugene A. Ludwig, commended the comparative study of banking systems and argued that American banks must not be encumbered with restrictions that are not applied to their international competitors if they are expected to continue facilitating the nation's economic growth in the twenty-first century); see also LEWIS & PESCIOTTO, *supra* note 1, at 192 (concluding that the American banking system is much more restrictive than that of the European Union and emphasizing the need for reform of the United States' regulatory system to enable American banks to compete internationally).

11. See *Developments in Banking Law: 1997*, *supra* note 5, at 2 (explaining that Congress has made many attempts over the past several years to repeal the Glass Steagall Act of 1933 and to reform the American banking laws, only to be thwarted by powerful interest groups).

12. See J. Virgil Mattingly & Keiran J. Fallon, *Understanding the Issues Raised by Financial Modernization*, 2 N.C. BANKING INST. 25, 26 (1998) (identifying the major parties involved in the continuing debate concerning financial modernization including: banking, insurance, and securities industries; the Treasury Department; the Federal Reserve Board; the Office of the Comptroller of the

needs to be revamped,¹³ the complex web of policy,¹⁴ economic,¹⁵ and supervisory interests¹⁶ has made the creation of an acceptable financial modernization proposal a daunting task for Congress. Despite numerous hurdles, however, Congress persists in taking action to revolutionize the way the United States runs its banking industry.¹⁷

On January 6, 1999, the House Banking and Financial Services Committee of the United States House of Representatives, introduced House Bill 10, the Financial Services Act of 1999 ("H.R. 10" or "financial reform legislation").¹⁸ H.R. 10 represents Congress' most recent effort to achieve the elusive goal of reforming the nation's financial services laws.¹⁹ Although previous reform efforts have failed,²⁰ the 106th Congress is bringing financial reform legisla-

Currency; the Federal Deposit Insurance Corporation; and the Securities and Exchange Commission).

13. See *id.* (explaining that the key parties directly affected by the debate for financial modernization agree that financial reform is necessary to establish a solid foundation for the American financial system in the new millenium).

14. See *id.* at 27 (identifying policy issues implicated by banking reform, such as the need to restructure the nation's current financial system in an efficient, safe, and sound manner so as not to unduly endanger depositors and the federal safety net).

15. See *id.* at 26 (discussing economic interests, such as providing American customers with a full array of financial products and services and thereby enabling American banks to compete effectively for financial services in the global arena).

16. See *id.* at 40 (highlighting supervisory issues, such as whether there is a need for umbrella supervision, in addition to functional supervision of the increasingly complex and diverse subparts of financial conglomerates).

17. See Brian Collins, *Once Clinton's Trial is Over, Gramm Ready to Move*, NAT'L MORTGAGE NEWS, Jan. 18, 1999, available in LEXIS, NEWS library (announcing that the new Senate Banking Committee Chairman, Senator Phil Gramm, is listening to all interested parties in financial reform to foster bipartisan consensus and enable the passage of a financial services modernization bill).

18. See H.R. 10, 106th Cong. (1999) (passed by the full House of Representatives on July 1, 1999).

19. See Collins, *supra* note 17 (reporting on Senator Phil Gramm's announcement of his intention to use 1998's financial services modernization bill, H.R. 10, as a starting framework for financial reform in 1999).

20. See *Why the Magna Bank Case Is So Significant*, NAT'L UNDERWRITER: LIFE & HEALTH/FIN. SERVS. ED., Jan. 18, 1999, available in LEXIS, NEWS li-

tion closer to enactment than ever before.²¹ This significant stride is due, in part, to the enthusiasm for reform in both the House²² and the Senate.²³ In fact, even if this year's financial reform legislation is not enacted, Congress will undoubtedly reintroduce similar reform legislation in the upcoming year, as the need to revamp the domestic banking regulatory structure will not disappear. Accordingly, a study of the proposed legislation's innovative provisions²⁴ will facilitate a better understanding of what banking in the twenty-first century may look like and how the proposed national banking regime will compare to its international competitors.²⁵

This Comment examines H.R. 10's proposed liberalization of the

brary (recognizing that although the 105th Congress did not achieve financial modernization, it bequeathed a feasible blueprint for reform to the 106th Congress, drafted after much negotiation and compromise among the interested industries).

21. The House Banking and Financial Services Committee passed an earlier draft of H.R. 10 on February 27, 1999; the House Commerce Committee passed a revised version of H.R. 10 on June 15, 1999. Finally, the full House of Representatives passed its final version of H.R. 10 on July 1, 1999. In addition, the United States Senate Banking Committee passed its version of H.R. 10 financial reform legislation on May 6, 1999. *See* Modernization Act of 1999, S.900, 106th Cong. (1999).

22. *See* Ola Kinnander, *Bank Deregulation: Leach Introduces Similar Measure*, BOND BUYER, Jan. 8, 1999, available in LEXIS, NEWS library (announcing that the House Banking and Financial Services Committee introduced legislation to dismantle the current regulatory framework that separates the banking, insurance, and securities industries, and that it plans to hold hearings and subsequently mark up the bill).

23. *See* Lynn Stevens Hume, *Banking Committee Hopes to Pass Financial Reform Bill in February*, BOND BUYER, Jan. 13, 1999, available in LEXIS, NEWS library (stating that Senator Phil Gramm set forth an aggressive agenda of banking goals).

24. *See* H.R. 10, 106th Cong. sec. 101 (1999) (repealing sections 20 and 32 of the Glass Steagall Act, which would liberalize the legal barriers that currently prevent commercial banks from affiliating with securities firms).

25. *See* OFFICE OF THE COMPTROLLER OF THE CURRENCY, *supra* note 9, at 3 (identifying the key global competitors as the European Union, Japan, and the United States, and analyzing the range of activities their banks are permitted to engage in). The Comptroller's study also highlighted that while the securities activities of banks in the European Union are unrestricted, the United States is the most restrictive of all countries in permitting banks to engage in the broad array of activities that are sought after in the global financial marketplace. *See id.*

securities powers²⁶ of commercial banks²⁷ in the United States and contrasts it with the currently deregulated banking structure of the European Union's Second Banking Directive.²⁸ Part I sets forth the present legal framework governing the securities powers of commercial banks in the United States. Part II contrasts this national scheme with the legal framework governing commercial banking and securities activities in the European Union. Part III analyzes the proposed securities powers for American commercial banks under H.R. 10 and compares them to the powers of commercial banks under the universal banking structure²⁹ maintained in the European Union. Part IV

26. See MACEY & MILLER, *supra* note 1, at 496 (describing securities powers as activities such as: (1) owning and holding securities for an institution's own account; (2) brokerage, the process of uniting a buyer and a seller of a security for a commission; (3) dealing, the business of maintaining a stock of securities and buying and selling them in the market with the goal of making a profit on the difference between the sales price and the purchase price; and (4) underwriting, the process of distributing securities to the public). The Glass Steagall Act, part of the Banking Act of 1933, regulates the securities powers of commercial banks in the United States and was enacted because of Congress' belief that the commingling of the business of banking with that of dealing in securities was a dangerous combination. See *id.* at 495-96.

27. See LEWIS & PESCIOTTO, *supra* note 1, at 111-12 (defining an American commercial bank as a financial institution funded by demand deposits, time and savings deposits, and short-term loans made to businesses, with the ultimate goal of providing financial assistance to businesses). Although not originally part of their function, commercial banks also are increasingly participating in the mortgage markets. See *id.* Additionally, the Federal Deposit Insurance Corporation ("FDIC") was created by the Banking Act of 1933 with the purpose of supervising, regulating, and insuring commercial bank depositors. See *id.* The Banking Act of 1933, in addition to creating the FDIC, proscribed commercial banks from dealing in securities with the Glass Steagall provisions, which divorced commercial banking activities from investment banking activities in the United States. See *id.* at 74.

28. See Second Council Directive 89/646 of Dec. 15, 1989 on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions and Amending Directive 77/780/EEC, 1989 O.J. (L 386) 1 [hereinafter Second Banking Directive] (reforming the European Union's financial services industry).

29. See LEWIS & PESCIOTTO, *supra* note 1, at 126-27 (defining universal-type banking systems as those where a single bank can provide a wide array of services). The services that a universal bank can provide include both commercial banking — for example, retail, wholesale, and service banking — and investment

examines the potential problems that may arise from financial reform if H.R. 10 or similar legislation is enacted. Part V makes several recommendations for liberalization of the domestic banking industry in light of the European Union's experiences with a deregulated financial services structure. Finally, this Comment concludes that while domestic financial reform is needed, Congress should consider the success of the European Union's Second Banking Directive and re-evaluate whether H.R. 10's current approach to reform, which restricts corporate structure and maintains the present supervisory regime, is an adequate response to the internationalization of the banking marketplace.

I. THE LEGAL FRAMEWORK GOVERNING COMMERCIAL BANKING AND SECURITIES ACTIVITIES IN THE UNITED STATES

A. HISTORICAL OVERVIEW: THE DIVORCE OF COMMERCIAL AND INVESTMENT BANKING BY THE GLASS STEAGALL ACT

Before 1900, although no formal law proscribed a commercial bank from engaging in securities activities,³⁰ distinct and separate entities conducted investment banking activities³¹ in the United

banking — for example, the stock market, securities, insurance, and real estate. *See id.* at 126; *see also* MACEY & MILLER, *supra* note 1, at 723 (explaining that the European Union operates under a liberal style of universal banking that is arguably the least restrictive in the world). The European Union's system allows banks to engage in the taking of deposits, consumer and commercial lending, securities underwriting and trading, mutual fund operations, investment counseling, and the holding of large equity shares in commercial, industrial, and insurance companies. *See id.*

30. *See* David M. Eaton, *The Commercial Banking-Related Activities of Investment Banks and Other Nonbanks*, 44 EMORY L.J. 1187, 1192 (1995) (describing the evolution of commercial and investment banking activities in the United States and indicating that, although there was no statutory prohibition, judicial decisions effectively prohibited the intermingling of the two industries).

31. *See* LEWIS & PESCIOTTO, *supra* note 1, at 126 (stating that investment banking activities encompass areas such as the stock market, securities, insurance, and real estate).

States. After the passage of the McFadden Act³² in 1927, commercial banks chartered by the federal government were explicitly permitted to conduct securities activities.³³ Consequently, commercial banks expanded their investment banking activities significantly until the Crash of 1929 and the Great Depression that followed.³⁴

Congress responded to the economic depression of the 1930s by passing the Banking Act of 1933.³⁵ This remedial legislation accomplished two key goals that continue to characterize the nation's banking laws today.³⁶ First, the legislature divorced commercial banking from investment banking by enacting the Glass Steagall Act, a portion of the Banking Act of 1933.³⁷ The underlying justification for this separation was the promotion of bank soundness.³⁸ Second,

32. See McFadden Act, Pub. L. No. 639, 44 Stat. 1224 (1927) (codified as amended in scattered sections of 12 U.S.C.).

33. See Casey K. McGarvey, *Federal Regulation of Bank Securities Activities: Will Congress Allow Glass-Steagall to be Shattered?*, 12 J. CONTEMP. L. 99, 103-04 (1986) (stating that Section 2(b) of the McFadden Act implicitly allowed national banks to conduct investment activities under the authority of the Comptroller of the Currency).

34. See Bernard Shull & Lawrence J. White, *The Right Corporate Structure for Expanded Bank Activities*, 115 BANKING L.J. 446, 451(1998) (noting that in 1927 the McFadden Act explicitly authorized commercial banks to purchase and sell marketable debt instruments, and that the Comptroller of the Currency also permitted commercial banks to underwrite all debt securities and the banks' affiliates to underwrite both debt and equities).

35. Banking Act of 1933, Pub. L. No. 66, 48 Stat. 162 (1933) (codified in scattered sections of 12 U.S.C.).

36. See MACEY & MILLER, *supra* note 1, at 22 (affirming that the antiquated Glass Steagall Act provisions still prevail in the American financial system today).

37. See Banking Act of 1933, Pub. L. No. 66, 48 Stat. 162 (1933) (codified in scattered sections of 12 U.S.C.). The Glass Steagall Act is the popular name given to Sections 16, 20, 21, and 32 of the Banking Act of 1933 and those provisions are codified respectively as amended at 12 U.S.C. Sections 24 (seventh), 377, 378(a), 78 (1994). See *id.*

38. See Joseph J. Norton & Christopher D. Olive, *The Ongoing Process of International Bank Regulatory and Supervisory Convergence: A New Regulatory-Market "Partnership"*, 16 ANN. REV. BANKING L. 227, 259-60 (1997) (explaining that during the Great Depression in 1933, a subcommittee of the United States Senate Banking Committee held a series of hearings during which many prominent speakers alleged abuse in the securities activities of commercial banks and their

the legislature created the Federal Deposit Insurance Corporation ("FDIC").³⁹ The FDIC was also established to foster bank soundness by providing federal deposit insurance to all national banks and qualifying state-chartered commercial banks.⁴⁰

The Glass Steagall Act, the more important statute for the purposes of this Comment, consists of four interrelated provisions: sections 16, 20, 21, and 32. Essentially, sections 16 and 21 prevent commercial and investment banks from encroaching upon one another's territory.⁴¹ Specifically, section 16⁴² prohibits commercial banks from engaging in certain areas of the securities business, while section 21⁴³ proscribes securities firms from engaging in commercial banking activities, such as the business of deposit-taking.⁴⁴ Addition-

affiliates, and concluded that such abuse was the primary catalyst behind the collapse of the American banking industry and the failure of over forty percent of all domestic commercial banks between 1929 and 1933).

39. See MACEY & MILLER, *supra* note 1, at 22 (observing that the Banking Act of 1933 established federal deposit insurance for designated members of the Federal Reserve System and created the FDIC to supervise the system).

40. See *id.* at 54 (explaining that bank runs and panics, such as those that occurred during the Great Depression, are rare today because federal deposit insurance insures accounts at qualified banks up to \$100,000 per depositor per institution).

41. See *id.* at 497 (suggesting that Sections 16 and 21 be thought of as limiting the opportunities for commercial and investment banks to cross territorial lines).

42. See 12 U.S.C. sec. 24 (1994) (proscribing national banks from underwriting, selling, and dealing in specified securities).

43. See 12 U.S.C. sec. 378 (1994) (forbidding investment banks or persons engaged in investment banking activities from receiving deposits, and thus from conducting commercial banking activities).

44. See Norton & Olive, *supra* note 38, at 262 (recognizing that section 21 of the Glass Steagall Act proscribes any individual involved in the business of issuing, underwriting, selling, or distributing securities from simultaneously conducting deposit-taking activities). *But see* Jonathan R. Macey & Geoffrey P. Miller, *Nondeposit Deposits and the Future of Bank Regulation*, 91 MICH. L. REV. 237, 237 (1992) (explaining that, notwithstanding the Glass Steagall Act, investment banks have penetrated traditional commercial banking functions, such as deposit taking via a deposit equivalent called a nondeposit deposit). A nondeposit deposit is an account that functions like a checking account deposit, but is not classified as a deposit for federal deposit insurance purposes or Federal Reserve Board capital reserve requirements. See *id.* This article argues that the nondeposit deposit is an

ally, sections 32 and 20 limit affiliations between commercial and investment banks.⁴⁵ Section 32 prohibits the sharing of staff or management across the commercial banking and investment banking industries,⁴⁶ while section 20 regulates affiliations between firms participating in commercial and investment banking.⁴⁷ Collectively, Congress intended these four sections to create a solid legal barrier, separating the investment and commercial banking industries.⁴⁸ Congress designed this separation during the 1933 hearings on banking reform, just prior to passing the Banking Act of 1933. At the hearings, Congress concluded that such a separation would prevent the emergence of the "subtle hazards" that it attributed to the commingling of the two industries.⁴⁹

During its first thirty years of existence, the Glass Steagall Act remained substantially untouched.⁵⁰ In the mid-1960s, however, commercial banks and regulators refocused their efforts on the securities industry in order to broaden national bank powers.⁵¹ Despite

oxymoron in banking law because it serves a commercial banking purpose, while not being subjected to the expensive regulatory framework traditionally applicable to such a service. *See id.*

45. *See* MACEY & MILLER, *supra* note 1, at 497 (observing that sections 32 and 20 were intended to curb contact between commercial and investment banks).

46. *See* 12 U.S.C. sec. 78 (1994) (prohibiting a person involved in any manner with the business of investment banking from acting as an officer, director, or employee of a FDIC member bank).

47. *See* 12 U.S.C. sec. 377 (1994) (prohibiting affiliations between any Federal Reserve member bank and companies principally engaged in the issue, flotation, public sale, underwriting, or distribution of any type of security).

48. *See* Shull & White, *supra* note 34, at 451-52 (remarking that Congress revoked the securities powers that the McFadden Act of 1927 accorded commercial banks by passing the Glass Steagall provisions of the Banking Act of 1933).

49. *See generally* Joan M. LeGraw & Stacey L. Davidson, Note, *Glass-Steagall and the "Subtle Hazards" of Judicial Activism*, 24 NEW ENG. L. REV. 225 (1989) (describing the 1933 Congressional hearings on banking reform and the subtle hazards that justified change in the industry).

50. *See* Norton & Olive, *supra* note 38, at 263 (explaining that entry into the securities industry was not particularly appealing to commercial banks because many securities firms failed with the banks).

51. *See id.* (discussing the Office of the Comptroller of the Currency's challenge of the Glass Steagall Act's restrictions on two occasions).

these efforts, the attempt to expand the banks' powers ultimately failed.⁵² In effect, in 1971, the United States Supreme Court, in *Investment Company Institute v. Camp*,⁵³ reiterated the 1933 congressional hearing's subtle hazards justification⁵⁴ for the Glass Steagall Act's separation of commercial and investment banking activities.⁵⁵

B. THE PRESENT POWERS AND FIREWALLS OF AMERICAN COMMERCIAL BANKS

Although the Glass Steagall Act created a wall that separates commercial from investment banking, this wall is not impenetrable.⁵⁶ The first loosening of the strictures came with the creation of entities known as Bank Holding Companies ("BHCs").⁵⁷ Given that these

52. See *id.* (demonstrating that the Office of the Comptroller of the Currency ultimately failed in its effort to reform the Glass Steagall Act during the 1960s).

53. 401 U.S. 617 (1971).

54. See *id.* at 630-37 (supporting Congress' subtle hazards rationale). The subtle hazards that occur when a commercial bank enters into the business of investment banking directly or indirectly through an affiliate include: (1) an adverse effect on public confidence if the bank or affiliate performs poorly because of the association in the mind of the public; (2) the risk of unsound loans to the ailing affiliate in an effort to raise public confidence; (3) the risk that the bank may provide credit more freely to companies in which the affiliate has a vested interest; (4) the risk that the bank may act more as a salesman rather than as an unbiased source of credit; (5) diminished customer goodwill if losses are incurred because of the affiliate; (6) loss of reputation for prudence and restraint because of investment banking needs; (7) temptation to make loans merely to facilitate the purchase of more securities; and (8) conflicts of interest between the need to offer impartial advice as a commercial bank and the salesman's interest as an investment bank. See *id.* at 631-33.

55. See Norton & Olive, *supra* note 38, at 264 (remarking that the *Investment Company Institute v. Camp* decision provided American courts and the federal banking legislators with the flexibility to analyze a range of factors when determining whether to permit a commercial bank to engage in non-traditional banking activities under the Glass Steagall Act).

56. See MACEY & MILLER, *supra* note 1, at 523 (declaring that banking firms persist in making inroads into the business of investment companies).

57. See LEWIS & PESCIOTTO, *supra* note 1, at 74 (explaining that the creation of entities known as holding companies defeated the intended purpose of the Glass Steagall Act, which was to separate the commercial and investment banking industries).

new entities were not banks, they were not implicated or limited by the Glass Steagall Act's proscriptions.⁵⁸ Consequently, BHCs freely purchased both commercial and investment banks and ultimately served to circumvent the mandates of the Glass Steagall Act.⁵⁹

In response to the new BHC entities, Congress enacted The Bank Holding Company Act of 1956 ("BHCA")⁶⁰ and closed a major loophole in the Glass Steagall provisions by requiring BHCs⁶¹ to divest themselves of non-banking interests.⁶² The general rule of the BHCA is that a BHC is prohibited from acquiring direct or indirect control over a company that is not a bank.⁶³ This general rule, however, is subject to numerous exceptions.⁶⁴

The most important exception to the general rule of the BHCA is set forth in section 4(c)(8).⁶⁵ Section 4(c)(8) states that the Federal Reserve Board ("FRB") may permit a BHC to acquire or control a non-banking company if its activities are "so closely related to banking or managing or controlling banks as to be a proper incident

58. *See id.* (commenting that holding companies were not banks and consequently were not subject to the same parameters of the Glass Steagall Act, under which banks had to function).

59. *See id.* (observing that the Glass Steagall Act could not prevent BHCs from purchasing both commercial and investment banks).

60. 12 U.S.C. sec. 1841-1850 (1994). Congress passed the Bank Holding Company Act of 1956 to restrict and regulate the increasing number of BHCs and defined a BHC as a corporation capable of voting a 25 percent share of two or more banks. *See* LEWIS & PESCIOTTO, *supra* note 1, at 74.

61. *See* 12 U.S.C. sec. 1841(a) (1994) (defining a BHC as any company controlling a bank or a company that is currently or will become a BHC under the auspices of the BHCA).

62. *See* Norton & Olive, *supra* note 38, at 264 (observing that the stated purpose of the BHCA was to require BHCs to divest themselves of non-banking interests).

63. *See* 12 U.S.C. sec. 1843(a) (providing that any company that acquires a bank has two years to divest itself of its non-banking components).

64. *See* 12 U.S.C. sec. 1843(c) (setting forth fourteen exemptions to the general rule prohibiting BHCs from acquiring control over an entity that is not a bank).

65. *See* Norton & Olive, *supra* note 38, at 265 (identifying section 4(c)(8) as the main vehicle through which BHCs conduct securities activities).

thereto.”⁶⁶ Accordingly, section 4(c)(8) serves as an avenue through which BHCs may conduct securities-related activities in their non-bank, or section 20 subsidiaries.⁶⁷ Thus, this framework enabled BHCs, with both banking and non-banking subsidiaries, to significantly increase their securities activities.⁶⁸

To protect FDIC-insured commercial banks from the risks associated with expanded securities underwriting and dealing activities within the BHC structure, in 1987 and 1989 the FRB created twenty-eight restrictions, commonly known as section 20 firewalls.⁶⁹ These firewalls⁷⁰ constituted legal barriers insulating the traditional commercial bank from the riskier activities of its securities affiliates.⁷¹ The FRB intended the firewalls to foster a legal framework of corporate independence and to shelter commercial banks from their non-bank affiliates' more speculative ventures.⁷² To achieve this end, the firewalls placed limitations on financial transactions and on the cir-

66. See 12 U.S.C. sec. 1843(c)(8) (delineating that the FRB must, when determining whether a specific activity is properly incident to the business of banking or to the management or control of banks, balance the potential benefits to the public, such as increased convenience, heightened competition, or gains in efficiency, against the possible negative effects, such as excessive concentration of resources, reduced or unfair competition, conflicts of interest, or unsafe banking practices).

67. See Norton & Olive, *supra* note 38, at 265 n.124 (stating that a BHC's subsidiaries are bank affiliates within the meaning of section 20 subsidiaries).

68. See *id.* at 265 (describing section 4(c)(8) as the most significant exception to the BHCA).

69. See *Developments in Banking Law: 1997*, *supra* note 5, at 95-6 (indicating that the FRB created restrictions intended to eliminate the risk of securities activities being imposed on FDIC-insured banks, and that these twenty-eight restrictions were commonly called section 20 firewalls).

70. See *Legislative Proposals to Restructure Our Financial System: Hearings on S. 186, S. 1891, and S. 1995 Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 100th Cong. 93 (1988) (statement of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System), *reprinted in* 74 FED. RESERVE BULL. 91, 96 (1988) (defining “firewalls” as barriers created to insulate banks from the risks associated with the securities industry).

71. See SHULL & WHITE, *supra* note 34, at 458-59.

72. See *id.*

ulation of information within the BHC structure.⁷³ In 1997, however, the FRB discarded most of the section 20 firewalls that previously had protected a BHC's commercial bank from its securities activities.⁷⁴

Outside of the BHC framework, the securities activities of commercial banks also expanded due to liberal interpretations of the Glass Steagall Act by the Office of the Comptroller of the Currency ("OCC").⁷⁵ The OCC permits commercial banks to engage in an expansive array of securities and securities-related activities, such as the underwriting of United States government, state, and municipal obligations.⁷⁶ At present, the only two significant banking activities that national commercial banks appear to be proscribed from engaging in are the general underwriting of securities that are not their own, and the purchasing of equity and other bank-ineligible securities for their own accounts.⁷⁷

In sum, judicial deference to aggressive regulatory decisions⁷⁸ permitting increased securities activities by commercial banks and BHCs, combined with the erosion of the protective firewalls, has fueled the *de facto* disintegration of the Glass Steagall wall — a wall that was designed to prevent commercial banks from engaging in se-

73. *See id.*

74. *See Developments in Banking Law: 1997, supra* note 5, at 102-03 (recognizing that the FRB abandoned almost all of the section 20 firewalls that separated a BHC's securities subsidiary from its depository institution and discussing what little remains of the section 20 firewalls).

75. *See* NORTON & OLIVE, *supra* note 38, at 277 (observing that the OCC's liberal interpretation of what constitutes the business of banking enables national banks to engage in expanded securities activities).

76. *See id.* at 268-72 (setting forth an expansive list of permitted securities activities for commercial banks).

77. *See id.* at 271 (analyzing the permissible activities list for commercial banks).

78. *See generally* NationsBank v. Variable Annuity Life Ins. Co., 513 U.S. 251 (1995) (permitting a deferential stance toward OCC's reading of federal banking laws and its interpretation of which activities are closely related to banking); Clarke v. Securities Indus. Ass'n, 479 U.S. 388 (1987) (accorded deference to the regulatory agencies' interpretations of which activities are closely related to banking).

curities activities altogether.⁷⁹ The aforementioned developments in the financial services industry underscore the necessity that Congress move swiftly to reform the nation's banking laws. Given that the European Union has committed itself to the deregulation and harmonization of its financial services industry over the past few decades,⁸⁰ an analysis of its regulatory framework could provide the American banking industry with insight into a more liberal banking system — a system where banks are permitted to offer corporations and consumers a broader selection of services in both commercial and investment banking.⁸¹

II. THE LEGAL FRAMEWORK GOVERNING COMMERCIAL BANKING AND SECURITIES ACTIVITIES IN THE EUROPEAN UNION

A. HISTORICAL OVERVIEW: THE DEVELOPMENT OF UNIVERSAL BANKING BY THE SECOND BANKING DIRECTIVE

Since the signing of the Treaty of Rome in 1957,⁸² the European Union⁸³ has concentrated on the deregulation and harmonization of

79. See *Why the Magna Bank Case is so Significant*, *supra* note 20 (asserting that continued delay in financial reform by Congress will result in a marketplace that evolves haphazardly according to institutional preferences and turf concerns of federal regulators).

80. See LEWIS & PESCIOTTO, *supra* note 1, at 7 (observing that the European Union has focused its efforts on deregulating and harmonizing the financial services industry since the 1957 Treaty of Rome). Beginning in the mid-1970s, it focused on harmonizing financial regulation. *Id.* at 7-8.

81. See *id.* at 192 (identifying economies of scope and greater economic development as benefits that result from the European Union's Universal banking system).

82. See Treaty Establishing the European Economic Community, Mar. 25, 1957, 298 U.N.T.S. 11 (1958) [hereinafter EEC Treaty], art. 1 (uniting six European countries to form the EEC: Belgium, West Germany, France, Italy, Luxembourg, and the Netherlands).

83. See *id.* (establishing the European Economic Community). In 1986, the European Community enacted the Single European Act and declared as its objective the establishment of European unity. See Single European Act, Feb. 28, 1986,

its financial services industry.⁸⁴ To attain this objective, the Treaty of Rome provided the European Commission⁸⁵ with the authority to pass regulations and directives, to make decisions and recommendations, and to issue opinions.⁸⁶ With these expansive powers, from 1957 through 1973 the European Union concentrated on deregulating the process of entry into domestic financial markets to foster a level playing field in the financial services industry.⁸⁷ Notwithstanding this deregulatory action, the lack of uniformity in banking supervisory laws continued to stymie international competition.⁸⁸ In response, the

1987 O.J. Eur. Comm. (L 169) 1, 4 (1987), 2 C.M.L.R. 741, 742 (1987), 25 I.L.M. 503, 507 (1986). Finally, on November 1, 1993, the Treaty on European Union took effect and is commonly referred to as the Maastricht Treaty. *See* Treaty of the European Union, Feb. 7, 1992, O.J. (C 224) 1 (1992), 1 C.M.L.R. 719. The treaty announced that the members would no longer be called the European Community, but would be referred to as the European Union. *See id.* art. A. at 5. For consistency, the term European Union will be used throughout this Comment.

84. *See* LEWIS & PESCIOTTO, *supra* note 1, at 7 (identifying the deregulation and harmonization of financial services in the EEC as a key goal of the Treaty of Rome).

85. *See id.* (stating that the European Commission has been taking measures to deregulate and harmonize the supply of financial services in the European Union since 1957). In 1965, the Merger Treaty was signed, establishing a single Council and a single Commission of the European Union, now referred to as the European Commission. *See* Treaty Establishing A Single Council and a Single Commission of the European Communities, Apr. 8, 1965, O.J. (L 152) 1 (1965), 4 I.L.M. 776 [hereinafter Merger Treaty]. The Council is the chief legislative body of the European Union and represents the concerns of the Member states. *See id.* The European Commission is the European Union's chief administrative body. *See id.* European Commission members are civil servants who do not accept orders from their respective country's governments. *See id.*

86. *See* EEC Treaty, *supra* note 82, art. 189 (as amended) (stating that regulations shall apply generally, be binding in all respects and be directly applicable within each Member State; directives shall bind any Member States they address, while respecting the competence of domestic agencies regarding form and means; decisions shall bind in every aspect the addressee named therein; recommendations and opinions have no authority to bind).

87. *See* LEWIS & PESCIOTTO, *supra* note 1, at 7 (explaining that the deregulation of commercial banks' entry into domestic financial markets culminated in the adoption of a 1973 Council directive based on the principle of national treatment to promote equal treatment of commercial banks in the European Union).

88. *See id.* (commenting that the lack of coordination in banking regulations

European Union refocused its efforts on the coordination of regulations within its financial system.⁸⁹

The adoption of the First Banking Directive⁹⁰ by the European Commission in 1977 constituted the European Union's first major attempt to harmonize European banking laws.⁹¹ The First Banking Directive consists of several provisions that significantly reformed the financial services industry in the European Union for credit institutions, also known as commercial banks.⁹² The key provisions of the First Banking Directive can be categorized into five general groups for harmonization purposes: (1) rules eliminating banking service barriers along Member State borders; (2) rules promoting the free establishment of branches by European credit institutions in other Member States; (3) uniform rules for key authorization requirements for credit institutions; (4) uniform rules for key supervisory standards; and (5) rules mandating equal treatment of non-European Union credit institutions.⁹³

Although the First Banking Directive sought to liberalize the banking laws of the European Union, it continued to restrict Inter-

continued to restrict international competition).

89. See *id.* at 7-8 (highlighting the European Union's redirected interest in the unification of financial regulations).

90. See Council Directive 77/780 of 12 December 1977 on the Coordination of the Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions, 1977 O.J. (L 322) 30 [hereinafter First Banking Directive] (reforming the European Union's banking laws).

91. See LEWIS & PESCIOTTO, *supra* note 1, at 8 (asserting that the First Banking Directive paved the way to more current harmonization of banking regulations).

92. See First Banking Directive, *supra* note 90, art. 1 (defining a credit institution as an entity that receives deposits from the public and that offers credit for its own account); see also George S. Zavvos, *Banking Integration and 1992: Legal Issues and Policy Implications*, 31 HARV. INT'L L.J. 463, 478-79 (1990) (commenting that this definition encompasses financial institutions such as commercial banks and savings institutions).

93. See Michael Gruson & Werner Nikowitz, *The Second Banking Directive of the European Economic Community and Its Importance for Non-EEC Banks*, 12 FORDHAM INT'L L.J. 205, 207-08 (1989) (organizing the First Banking Directive provisions, which created the basis for the harmonizing of banking laws in the EEC, into five categories).

Member State banking services in certain respects.⁹⁴ For example, under the First Banking Directive, a host country could impose its authorization procedures on a credit institution seeking to set up a branch in that Member State. Each Member State was also permitted to maintain and impose domestic activity restrictions on a credit institution establishing a branch within its territory.⁹⁵ Thus, while the First Banking Directive constituted a significant first step towards financial reform, further action was needed to completely liberalize the European Union's banking laws.⁹⁶

In 1989, the European Union ultimately adopted its Second Banking Directive with the key goals of eliminating the remaining obstacles to the free establishment of bank branches and fostering complete liberty to provide financial services throughout the European Union.⁹⁷ Today, the Second Banking Directive is the governing law on financial services in the European Union.⁹⁸ The current directive creates a single passport⁹⁹ for banks to supply services throughout the European Union, and achieves this goal by permitting banks to provide an extensive list of banking services, subject to home

94. *See id.* at 208-09 (asserting that the First Banking Directive constituted only a preliminary step towards eliminating the need for host country authorization to conduct banking activities in the European Union).

95. *See id.* at 209-10 (indicating that barriers to the establishment of credit institution branches in other European Union Member States remained after the adoption of the First Banking Directive).

96. *See id.* (citing three legal barriers preventing Member states from establishing branches throughout the European Union even after the first Banking Directive: (1) host country authorization; (2) host country supervision; and (3) in most Member states, the requirement that branches, like new banks, be given specified endowment capital).

97. *See id.* at 210 (emphasizing that the goal of the Second Banking Directive is to foster a genuinely internal marketplace of banking services).

98. *See* LEWIS & PESCIOTTO, *supra* note 1, at 9 tbl. 1.1 (listing financial services directives implemented into law and recommendations issued from 1979 to 1995). The European Union issued the Second Banking Directive in 1989 and implemented it into law on January 1, 1993. *Id.* at 9.

99. *See id.* at 12-13 (indicating that a key feature of the Second Banking Directive is the creation of a single license for banks to offer services throughout the European Union).

country control and uniform standards across national borders.¹⁰⁰

In contrast to the American banking regime, the Second Banking Directive was founded on the universal banking model, which allows a bank to transact commercial and investment banking functions within the same corporate entity.¹⁰¹ The European Union embraced three key concepts in its Second Banking Directive to achieve this universal banking throughout the Union: (1) mutual recognition; (2) a single banking license; and (3) an agreed-upon list of banking activities.¹⁰²

First, mutual recognition mandates that if a service can be provided legally under specific conditions in one European Union country, it cannot be proscribed under similar conditions in another European Union country.¹⁰³ Second, the single banking license provides that once a bank is licensed by the proper authorities in its home country to engage in certain activities, it is permitted to transact those same activities in any other Member State under the single

100. *See id.* (listing the three types of directives that affected the European single market of financial services: (1) Capital Liberalization Directive; (2) Directives for Credit Institutions; and (3) Directives For Investment Services and Capital Adequacy).

101. *See* Second Banking Directive, *supra* note 28, at Annex List of Activities Subject to Mutual Recognition (identifying the securities activities that a credit institution may engage in, such as: trading for its own account or for the account of customers in long and short term securities; issuing of shares and related activities; managing of a portfolio and some investment banking activities, including those relating to mergers and acquisitions).

102. *See* Zavvos, *supra* note 92, at 481-82 (identifying three financial services models in the European Union prior to the implementation of the Second Banking Directive: (1) a universal banking model common to Germany and the Netherlands, in which commercial banks are licensed to participate in the securities services and a broad array of other financial services; (2) a hybrid model, which was common to the United Kingdom, France, and Greece, in which a bank's commercial banking and securities activities are separated by Chinese walls; and (3) the Belgian system, which strictly limits bank engagement in securities activities). The European Union viewed the adoption of mutual recognition, the single banking license, and the agreed-upon activities list as a means by which the Second Banking Directive could move all European Union countries towards Germany's universal banking model. *See id.*

103. *See* LEWIS & PESCIOTTO, *supra* note 1, at 12-13 (describing the principle of mutual recognition).

banking license.¹⁰⁴ Moreover, the single banking license is valid regardless of whether the activities are permitted in the host country, thereby eliminating the need to obtain a local banking license or authorization.¹⁰⁵ Finally, Article 18(1) of the Second Banking Directive provides that European Union countries must allow the activities listed in the Annex to the Directive to be carried on within their territories and that those activities are covered by home state authorization.¹⁰⁶

The consequences of the application of these three principles are significant. Essentially, one country's bank may gain a competitive advantage over another country's bank by providing the domestic customers with products that domestic banks are proscribed from offering, but that are permitted by the Second Banking Directive.¹⁰⁷ Thus, the regulatory body of the more restrictive country will have a strong incentive to level the playing field for its domestic banks by liberalizing its own regulations.¹⁰⁸ The end result is that regulatory agencies of each country in the European Union engage in competitive deregulation of the financial services industry.¹⁰⁹

104. *See id.* (observing that the implementation of the single banking license amounts to the mutual recognition of regulatory bodies regarding the Second Banking Directive's list of agreed-upon activities).

105. *See id.* at 12 (explaining that the Second Banking Directive embodies the philosophy that once a bank is permitted to conduct activities in its home country, it is also permitted to conduct those same activities in any European Union Member State, without the need for further permission).

106. *See* Second Banking Directive, *supra* note 28, art. 18(1) (mandating that Member States permit all the activities listed in the Annex to be conducted within their territories, in conformity with Articles 19-21).

107. *See* LEWIS & PESCIOTTO, *supra* note 1, at 12-13 (noting the competitive advantage a country fostering a more liberal banking regime may attain within the European Union).

108. *See id.* at 13 (highlighting the incentive structure of the Second Banking Directive).

109. *See id.* (describing the phenomenon of competitive deregulation within the European Union).

B. THE PRESENT POWERS AND FIREWALLS OF EUROPEAN COMMERCIAL BANKS

Compared to the current regulatory structure in the United States, European credit institutions, or commercial banks, enjoy expansive powers under the Second Banking Directive.¹¹⁰ The Directive's Annex sets forth the present powers of commercial banks in the European Union,¹¹¹ which are deemed integral to banking and for which, consequently, the single banking and mutual recognition principles will apply.¹¹² Most notably, commercial banks in the European Union are permitted to engage in trading for their own account, or for the account of their customers in securities, and are able to participate in share issuances and services related to such issues.¹¹³

110. *See id.* at 192 (stating that the United States' banking regulatory structure is the most restrictive of major industrialized countries).

111. *See* Second Banking Directive, *supra* note 28, at Annex List of Activities Subject to Mutual Recognition (establishing expansive powers for credit institutions in the European Union).

112. *See id.* (allowing banks to trade for their own account or for the accounts of their clients).

113. *See id.* (listing fourteen activities that can be conducted by any commercial bank within the European Union). The permissible activities are:

1. Accepting deposits and other repayable funds from the public.
2. Lending.
3. Financial leasing.
4. Money transmission services.
5. Issuing and administering means of payment (e.g. credit cards, travellers' cheques and bankers' drafts).
6. Guarantees and commitments.
7. Trading for own account or for account of customers in:
 - a. money market instruments (cheques, bills, CDs, etc.);
 - b. foreign exchange;
 - c. financial futures and options;
 - d. exchange and interest rate instruments;
 - e. transferable securities.

The Annex's list of permissible activities demonstrates that the Second Banking Directive explicitly permits commercial banks to enter into the securities business, and allows such activities to be conducted by the same corporate entity.¹¹⁴ Thus, the American notion of firewalls separating the traditional banking activities of a bank from its securities operations does not exist under the European Union's banking regime.¹¹⁵

The European Union's liberal policy regarding securities activities highlights a fundamental difference in the premises upon which the European Union and the United States have based their respective banking laws.¹¹⁶ While the United States traditionally has viewed the entry of commercial banks into expanded securities activities as increasing the risk to the health of the depository institution,¹¹⁷ the

8. Participation in share issues and the provision of services related to such issues.
9. Advice to undertakings on capital structure, industrial strategy and related questions and advice and services relating to mergers and the purchase of undertakings.
10. Money brokering.
11. Portfolio management and advice.
12. Safekeeping and administering securities.
13. Credit reference services.
14. Safe custody services.

Id.

114. See LEWIS & PESCIOTTO, *supra* note 1, at 92 (indicating that many countries, especially those in Europe, have increased their competitive edge through universal banking institutions, which allow a corporation to take care of all of its banking needs in one place).

115. See MACEY & MILLER, *supra* note 1, at 722-23 (explaining that the bank or financial services holding structure is unique to the American banking industry and that under the European Union's universal banking model any entity with a banking license may hold large equity shares in commercial, insurance, and industrial companies).

116. See Zavvos, *supra* note 92, at 481 (stating that European banks' entry into the securities business indicates the different premises upon which European Union and United States banking laws are based).

117. See LeGraw & Davidson, *supra* note 49, at 226 (explaining the traditional view that the risky and speculative nature of investment banking makes it undesir-

European Union's viewpoint is that such diversification actually decreases the risk.¹¹⁸ The European Union concluded that allowing commercial banks to participate in the securities industry diversifies their activities and thereby secures bank earnings when the traditional banking activities are less lucrative.¹¹⁹ In sum, the European Union views the adoption of the universal banking model as a means of improving its competitive position in the global marketplace.¹²⁰

III. MOVEMENT TOWARDS EXPANDED SECURITIES POWERS FOR AMERICAN COMMERCIAL BANKS

A. OVERALL MOVEMENT IN AMERICAN BANKING REFORM

In contrast to the European Union's innovative Second Banking Directive, the American banking industry is currently approaching the twenty-first century in a regulatory vehicle conceived in 1933.¹²¹ Accordingly, many top executives of domestic financial institutions lament that other countries are leaving the United States behind as the only developed country that has not lifted barriers segregating financial services.¹²² H.R. 10, the Financial Services Act of 1999, em-

able to commingle investment bank activities with commercial banks that are responsible for public savings).

118. See Zavvos, *supra* note 92, at 481 (commenting that the European Union believes that diversification, through participation in the securities industry, adds depth and liquidity to European banks).

119. See *id.* (noting the European Union's view that the securities activities of banks help banks maintain overall earnings when the conventional banking business is suffering from decreased profits).

120. See *id.* (contending that the adoption of the universal banking model by the European Union will increase its competitive position in the global marketplace because the European Union lacks nonbank securities houses, like those in the United States, and the European banks are the only institutions strong enough to provide capital for a modern securities market).

121. See Glass Steagall Act, Pub. L. No. 73-66, 48 Stat. 162 (1933) (codified in scattered sections of 12 U.S.C.) (preventing the affiliation among securities firms, insurance companies, and depository institutions; and legally segregating these financial services).

122. See Deborah McGregor, *Congress is Pressed on Bank Reform*, FIN. TIMES,

bodies Congress' most recent response to the industry officials' cries for reform.¹²³ This proposed legislation aspires to create a framework that facilitates more efficient and effective competition among the banking, securities, and insurance industries, while increasing consumer access to financial services, protecting investors, and fostering a safe and sound banking system.¹²⁴

B. DESCRIPTION OF THE PROVISIONS OF H.R. 10: THE PROPOSED SECURITIES POWERS FOR COMMERCIAL BANKS

The impetus behind financial reform legislation is the banking, securities, and insurance industries' desire to form strategic alliances in order to level the international banking playing field.¹²⁵ Accordingly, the main goals of the proposed legislation are, first, to repeal the provisions of the Glass Steagall Act that restrict banks and securities underwriters from affiliating,¹²⁶ and, second, to permit the creation of

Feb. 11, 1999, at 3 (reporting Congress' interest in reforming the financial services industry). David Comansky, Chairman and CEO of Merrill Lynch, testified before the House Banking Committee that the European Union has permitted its financial institutions to cross the lines and offer banking, securities, and insurance services and that Japan revamped its version of the antiquated Glass Steagall Act in 1998). *See id.*

123. *See id.* (reporting that James Leach, the Republican chairman of the House Banking Committee, asserted that he was determined to pass his current version of H.R. 10 for changing outmoded financial services laws in 1999).

124. *See* H.R. 10, 106th Cong. (1999) (declaring that the purpose of the proposed legislation is to augment competition in the financial services industry by providing a prudent framework for the affiliation among banks, securities companies, and other financial service providers, as well as additional purposes).

125. *See* McGregor, *supra* note 122, at 3 (reporting that top officials of American financial institutions continue to press Congress to reform domestic banking laws so other nations' less restrictive financial regimes will not reduce their presence in the international banking market).

126. *See* H.R. 10, 106th Cong. sec. 101 (1999) (repealing sections 20 and 32 of the Glass Steagall Act of 1933). Section 20 proscribes commercial banks from affiliating with an organization dealing in securities. *See* 12 U.S.C. sec. 377 (1994). Section 32 prohibits persons employed in the securities industry from serving concurrently as an officer, director, or employee of a commercial bank, unless specifically authorized to do so by the Board of Governors of the Federal Reserve System. *See* 12 U.S.C. sec. 78 (1994).

financial supermarkets¹²⁷ similar to those that currently exist abroad.¹²⁸

H.R. 10 is divided into five parts.¹²⁹ Basically these provisions do the following: Title I of the proposed legislation facilitates affiliation among securities firms, insurance companies, and depository institutions;¹³⁰ Title II discusses the functional regulation of the proposed financial conglomerates;¹³¹ Title III incorporates the insurance compromise worked out among the competing industries;¹³² Title IV provides guidelines for unitary savings and loan holding companies;¹³³ and Title V addresses privacy issues.¹³⁴ Title I comprises the more

127. See H.R. 10, 106th Cong. sec. 103 (1999) (amending the Bank Holding Company Act of 1956 to include financial holding companies; defining these new entities as those that comply with the eligibility requirements set forth in the legislation; and permitting the new entities to engage in any activity that the FRB has determined to be "financial in nature or incidental to such financial activities"); see also Clyde Mitchell, *H.R. 10 - So Near and Yet So Far*, N.Y.L.J., Oct. 21, 1998, at 6 (indicating that one of the primary goals of domestic financial reform was the formation of financial supermarkets).

128. See LEWIS AND PESCIOTTO, *supra* note 1, at 126 (identifying the European Union countries of Switzerland, France, Germany, and the United Kingdom as countries in which the United States has significant investments, and noting that all of these countries have universal-type banking systems, where one bank can offer a wide variety of services in both commercial and investment banking).

129. See generally H.R. 10, 106th Cong. (1999) (separating the legislation into five distinct titles).

130. See *id.* at tit. I (dealing with affiliations within the financial services industry, streamlining supervision of financial holding companies, subsidiaries of national banks, wholesale financial holding companies and institutions, national treatment, federal home loan bank system modernization, direct activities of banks, and deposit insurance funds).

131. See *id.* at tit. II (discussing brokers and dealers, bank investment company activities, Securities and Exchange Commission supervision of investment BHCs, and studies to be conducted).

132. See *id.* at tit. III (covering state regulation of insurers, redomestication of mutual insurance, and national association of registered agents and brokers).

133. See *id.* at tit. IV (preventing the creation of new savings and loan holding companies with commercial affiliates).

134. See *id.* at tit. V (including a requirement that financial institutions adopt precise privacy policies and advise their customers as to how the financial institutions intend to use customers' information).

important innovations for the purposes of this Comment because it repeals the restrictions of the Glass Steagall Act and establishes the regulatory framework for the proposed financial supermarkets.¹³⁵ Accordingly, the provisions of Title I are the primary focus of greater discussion below.

To facilitate affiliation among securities firms and depository institutions, Title I of H.R. 10 contains several principal provisions. First, it repeals sections 20 and 32 of the Glass Steagall Act, eliminating the restrictions on banks and securities underwriters from affiliating and sharing personnel.¹³⁶ Second, it creates a holding company structure by amending the BHCA¹³⁷ to include a provision applicable to financial holding companies ("FHCs").¹³⁸ Under this new regulatory structure, companies engaged in commercial banking, investment banking, and insurance activities may be owned and operated by a single FHC as long as the business conducted is "financial in nature or incidental to such financial activities."¹³⁹ Thus, permissible non-banking activities for FHCs are expanded significantly from those "closely related to banking"¹⁴⁰ to those that are "financial in nature."¹⁴¹

135. See H.R. 10, 106th Cong. secs. 101, 111 (1999) (amending the Glass Steagall Act of 1933 and creating the supervisory framework for financial conglomerates).

136. See *id.* sec. 101 (repealing sections 20 and 32 of the Glass Steagall Act of 1933).

137. See *id.* sec. 102 (amending section 4(c)(8) of the Bank Holding Company Act of 1956 and inserting after section 5 a new section 6 entitled Financial Holding Companies).

138. See *id.* sec. 103 (defining a financial holding company as a BHC which meets eligibility requirements pertaining to capitalization, management, community needs requirements, and foreign banks and companies).

139. See *id.* (stating that the FRB determines whether the activity is financial in nature, subject to Treasury Department approval, and setting forth factors to be considered in making such an assessment).

140. See 12 U.S.C. sec. 1843(c)(8) (1994) (permitting a BHC to engage in a new activity if it is judged by the FRB to be so closely related to the banking business or the management or control of banks as to be deemed a proper incident thereof).

141. See H.R. 10, 106th Cong. sec. 103 (1999) (enumerating factors to be considered by the FRB in determining whether an activity is financial in nature). Such factors include the purposes of the Financial Services Act of 1999, changes or rea-

Third, the proposed legislation contains a list of specifically authorized financial activities.¹⁴² If an activity is not mentioned on the list, the FRB may permit the FHC to conduct the additional activity if the FRB determines that the new activity is financial in nature.¹⁴³ In reaching its decision, H.R. 10 requires the FRB to consult with the

sonably anticipated changes in the marketplace or the technology for delivering financial services, and whether such activity is necessary to enable a BHC or FHC to compete effectively with any financial service company in the United States). *See id.*

142. *See id.* (listing activities considered financial in nature). Activities considered financial in nature, in which FHCs will be able to engage, include:

1. Lending, exchanging, transferring, investing for others, or safeguarding money or securities.
2. Insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, or providing and issuing annuities, and acting as principal, agent, or broker for purposes of the foregoing.
3. Providing financial, investment, or economic advisory services, including advising an investment company.
4. Issuing or selling instruments representing interests in pools of assets permissible for a bank to hold directly.
5. Underwriting, dealing in, or making a market in securities.
6. Engaging in any activity that the Board has determined, by order or regulation that is in effect on the date of enactment of the Financial Services Act of 1999, to be so closely related
7. Engaging, in the United States, in any activity that
 - i. a bank holding company may engage in outside the United States;
 - and
 - ii. the Board has determined . . . to be usual in connection with the transaction of banking or other financial operations abroad.
8. Directly or indirectly acquiring or controlling [a company] engaged in any activity not authorized pursuant to this section *Id.*

143. *See id.* sec. 103(c)(2) (citing factors the FRB should consider in making its determination of what activities are financial in nature).

Treasury,¹⁴⁴ which has the ultimate authority to veto a FRB determination.¹⁴⁵

Fourth, H.R. 10 designates the FRB as the umbrella regulator¹⁴⁶ of these FHCs, with functional regulation of the commercial banks, investment banks, and insurance companies in the structure delegated to the appropriate regulator.¹⁴⁷ Commercial banking activities would be subject to functional regulation by the OCC, the FDIC, or the appropriate state-banking department.¹⁴⁸ The Securities and Exchange Commission would oversee investment banking activities,¹⁴⁹ and the state insurance regulator would supervise insurance activities.¹⁵⁰

The financial reform legislation purports to streamline FHC supervision in two ways. First, H.R. 10 directs the FRB to depend, to the greatest extent possible, on reports the FHC has prepared for functional regulators,¹⁵¹ and, second, it limits examinations of functionally-regulated subsidiaries to circumstances in which the FRB has

144. *See id.* sec. 103(c)(1)(B) (mandating that the FRB shall consult with the Treasury Department concerning any application, request, or proposal to have an activity declared financial in nature).

145. *See* H.R. 10, 106th Cong. sec. 103 (1999) (indicating that the Treasury's view is supreme regarding what activities are financial).

146. *See id.* sec. 111 (giving the FRB the authority to collect reports from BHC and FHCs, and to conduct examinations of the entity); *see also* Mitchell, *supra* note 127, at 3 (explaining that the 105th Congress' proposed legislation designated the FRB as the umbrella regulator).

147. *See* H.R. 10, 106th Cong. sec. 111 (1999) (directing the FRB to rely upon reports submitted to the other federal and state supervisors or to the appropriate self-regulatory agencies to the fullest extent possible).

148. *See id.* (stating that the FRB shall accord deference to bank examinations and reports of depository institutions made by the appropriate federal and state depository institution regulatory authority).

149. *See id.* (mandating that functional regulation of the securities activities of the BHC or FHC will be deferred to the Securities and Exchange Commission and the relevant State securities authorities).

150. *See id.* (delegating functional regulation of insurance activities to the applicable State insurance authorities).

151. *See id.* (stating that the FRB must accept reports that the FHC has submitted to other federal and state supervisors or to appropriate self-regulatory organizations that fulfill the FRB's reporting requirements).

reasonable cause to believe an affiliated depository institution is facing material risk.¹⁵² Finally, to protect the overall safety and soundness of the FHC, H.R. 10 authorizes the FRB to impose prudential safeguards on transactions and relationships between a depository institution and its affiliates.¹⁵³ H.R. 10 indicates that those safeguards should be designed to eliminate hazards such as conflicts of interest and undue encroachment upon consumer privacy.¹⁵⁴ Additionally, the FRB's authority to impose restrictions upon the non-bank affiliates of the FHC is limited to what is necessary to prevent or rectify unsafe or unsound practices posing a material risk to the safety or soundness of the depository or payment system.¹⁵⁵

C. COMPARATIVE LEGAL ANALYSIS: IS H.R. 10 A COMPROMISE BETWEEN THE EUROPEAN UNION'S SECOND BANKING DIRECTIVE AND THE UNITED STATES' CURRENT BANKING SYSTEM?

The European Union's Second Banking Directive provides a good basis for comparison with the current movement in banking reform in the United States for several reasons. First, the United States identified the amelioration of its competitive position internationally as one of the principle goals of banking reform.¹⁵⁶ Second, the European Union is the forerunner in banking reform, currently maintaining the

152. See H.R. 10, 106th Cong. sec. 111 (1999) (granting the FRB the authority to examine each subsidiary of a BHC or FHC). The FRB may only make such examinations when there is reasonable cause to believe that the subsidiary is acting in a manner that may pose a material risk to an affiliated depository institution or in a way suggesting non-compliance with the mandates of the Financial Services Act of 1999). See *id.*

153. See *id.* sec. 114 (identifying public interest as a proper reason for which the FRB may impose restrictions or requirements on the affiliation between a depository institution and its non-bank affiliates).

154. See *id.* (citing additional purposes for imposing restrictions, such as enhancing the financial stability of banks, avoiding significant risk to the safety and soundness of the depository institution or any federal deposit insurance fund, and promoting the application of national treatment and equality of competitive opportunity).

155. See *id.* (setting forth the standard for the FRB's exercise of authority).

156. See *generally* H.R. 10, 106th Cong. (1999) (identifying the enhancement of the competitive position of American financial service providers internationally as one purpose of the proposed legislation).

most liberal financial system in the world.¹⁵⁷ Finally, the European Union has several years of experience in implementing its deregulated and reformed system of universal banking¹⁵⁸ to which the United States can look for guidance.

In beginning the comparative analysis, it is important to recognize the major policy difference between the United States and the European Union concerning the degree of safety built into their respective financial systems. While the European Union has integrated minimal protections in its Second Banking Directive,¹⁵⁹ the United States maintains an expansive system of protection and appears to continue at such a level in the prospective financial reform legislation.¹⁶⁰ With this policy distinction in mind, there is a notable divergence in American and European banking reform. Both the European Union and the United States seek to improve their global competitive positions. In terms of universal banking, however, American authorities, through H.R. 10, have proposed the so-called firewall or FHC approach,¹⁶¹ while the European Union, in its Second Banking Directive, has fostered the liberal German universal banking model.¹⁶²

The American holding company approach enables the bank entity of a FHC to participate in securities activities, "while maintaining a

157. See MACEY & MILLER, *supra* note 1, at 723 (commenting that Germany's and the European Union's universal banking model is debatably the most freestyle banking model in the world).

158. See generally JOÃO A. SANTOS, COMMERCIAL BANKS IN THE SECURITIES BUSINESS: A REVIEW (Bank for Int'l Settlements, Monetary and Econ. Dep't, Working Paper No. 56, 1998) (highlighting the major benefits of a liberal universal banking system, and looking to the examples of various European Union countries to bolster the argument).

159. See LEWIS & PESCIOTTO, *supra* note 1, at 189 (contrasting the European Union's conservative safety net in banking legislation with the more extensive system of protection present in the United States).

160. See H.R. 10, 106th Cong. sec. 103 (1999) (permitting more expansive financial activities to be conducted within the segregated structure of a FHC).

161. See *id.* (amending the Bank Holding Company Act of 1956 to include FHCs).

162. See MACEY & MILLER, *supra* note 1, at 724 (explaining that the European Union's implementation of the universal banking model in its Second Banking Directive encourages German-style banking throughout Europe).

structure that insulates its banking activities from the greater risks of securities trading."¹⁶³ In contrast, the European Union approach permits banks to conduct both commercial banking and securities activities without these protective firewalls.¹⁶⁴ Essentially, rather than restricting specific banking activities or mandating financial segregation through a holding company structure with firewalls, the European Union's regulations establish minimum standards of conduct and minimum requirements for the financial indices of stability.¹⁶⁵ One criticism of the proposed American FHC approach is that such a change does not truly revolutionize the domestic banking industry because banks will not be able to take advantage of expanded powers, given the inevitable result that most, if not all, of the benefits of diversification will accrue to the FHC and not to the banks.¹⁶⁶

In sum, Congress has proposed legislation that strives to enhance the international competitiveness of domestic banks without first thoroughly analyzing what has enabled the European Union's universal banks to perform so successfully and to become daunting competitors to American banking institutions.¹⁶⁷ The proposed finan-

163. LEWIS & PESCIOTTO, *supra* note 1, at 189; *see also* H.R. 10, 106th Cong. sec. 114 (1999) (empowering the FRB to enact prudential safeguards affecting the relationship between a FHC or BHC and an affiliated bank to prevent significant risk to the safety and soundness of the depository institution).

164. *See* MACEY & MILLER, *supra* note 1, at 723-24 (indicating that in the German or European Union universal banking model there are few separate legal entities, banks frequently hold commercial firms, and combinations of banking and insurance are common).

165. *See* LEWIS & PESCIOTTO, *supra* note 1, at 189 (explaining that the European Union opted for regulations imposing minimum standards for credit institutions rather than restricting the types of activities in which banks could engage).

166. *See* MACEY & MILLER, *supra* note 1, at 554 (questioning whether Alan Greenspan's proposal for the holding company structure as the means of achieving benefits from diversification into the securities industry would actually result in banks taking advantage of the additional powers, or whether such benefits would simply be enjoyed by the holding company); *see also* Shull & White, *supra* note 34, at 460 (commenting that the complete isolation of banks, as in a holding company structure, would undermine the main reason activity expansion has been sought out in financial reform, namely, to enable banks to benefit from economies of scope and diversification).

167. *See* SANTOS, *supra* note 158, at 8 (finding that research on banks in Japan,

cial reform legislation arguably does no more than repeal the Glass Steagall Act, while maintaining the currently fragmented, segregated, and protective structure of the BHCA, which grew out of a loophole in the Glass Steagall Act in 1956.¹⁶⁸ Consequently, the current movement of financial reform in the United States has struck a compromise between the revolutionary model of the European Union's Second Banking Directive and the current, highly regulated model of the American holding company structure. Basically, the following could result from the proposed financial reform legislation: on the one hand, American FHCs will be permitted to offer a more expansive array of financial services, similar to those in the Annex to the European Union's Second Banking Directive,¹⁶⁹ while on the other hand, American FHCs will not enjoy the full benefits of universal banking, such as information advantages and economies of scope.¹⁷⁰

Israel, and some European Union countries demonstrated stronger evidence of scope economies in the joint production of commercial and investment banking services in the universal banking model than seen in the American BHC model). Santos concludes that when countries provide their banks more freedom to choose their corporate structure in integrating securities and commercial banking activities, the banks usually decide to conduct these activities in-house — as in the German and European Union universal banking model — or to conduct them in a subsidiary of the bank — as in the United Kingdom. *See id.* at 19. Santos adds that the holding company model only prevails in the United States because of the United States' idiosyncratic regulatory structure, not because it is the most efficient model for integrating securities activities. *See id.*

168. *See* LEWIS & PESCIOTTO, *supra* note 1, at 74 (explaining that until the passage of the Bank Holding Company Act of 1956, BHCs were able to circumvent the Glass Steagall Act's segregation of commercial and investment banking activities through a loophole — because they were not banks, they were not subject to Glass Steagall's proscriptions).

169. *Compare* H.R. 10, 106th Cong. sec. 103 (1999) (listing the activities considered financial in nature and thus permissible for FHCs to engage in), *with* Second Banking Directive, *supra* note 28, at 13 (listing permissible activities for European credit institutions).

170. *See* SANTOS, *supra* note 158, at 18 (stating that corporate separateness limits a financial conglomerate's ability to exploit economies of scope, and that in the holding company model the relationship between the securities unit and the bank are only indirect).

IV. POTENTIAL PROBLEMS WITH THE CURRENT MOVEMENT IN AMERICAN BANKING REFORM

Proponents of domestic financial reform legislation are fervently lobbying for action that will help eliminate the constraints of the Glass Steagall Act.¹⁷¹ This attitude, however, is too impulsive in an industry that can be devastated by a flawed deregulatory policy, as so aptly demonstrated the savings and loan debacle of the 1980s.¹⁷² While H.R. 10 does indeed take the much needed step of repealing the restrictive provisions of the Glass Steagall Act, the proposed legislation contains significant problems that must be addressed before it is enacted.

A. THE CORPORATE STRUCTURE

In a deregulated financial system, there are a number of possible corporate structures banks can adopt to integrate commercial banking with securities activities.¹⁷³ The European Union permits its commer-

171. *See Hearings on Fin. Servs. Modernization Before the House Banking and Fin. Servs. Comm.*, 106th Cong. (1999) (chaired by Rep. Jim Leach), *reprinted in* FED. NEWS SERV., Feb. 10, 1999 [hereinafter *Hearings: Chaired by Jim Leach*] (reporting that Michael Patterson stated that the progress of H.R. 10 should not be stifled by quarrels over issues of regulatory supervision). Patterson contends further that Congress should not maintain obsolete laws because a consensus cannot be reached regarding how to readjust the regulatory structure to the new market reality. *See id.*

172. *See generally* LAWRENCE J. WHITE, *THE S&L DEBACLE: PUBLIC POLICY LESSONS FOR BANK AND THRIFT REGULATION* (1991) (discussing the deregulatory measures taken to modernize the savings and loan industry and commenting that while such deregulatory measures implemented in the early 1980s were desperately needed by the thrift industry, they were not accompanied by stronger safety and soundness regulations). White ultimately finds that the combination of economic deregulatory measures with the easing of safety-and-soundness rules created disaster for the thrift industry, the federal insurance fund, and the American taxpayer. *See id.* The author discerns important lessons from the savings and loan debacle and asserts that it is pertinent to recall those lessons in the future of bank, thrift, and deposit insurance regulation in the United States and in other countries seeking to prevent the repetition of the costly errors that the United States Government committed during the 1980s. *See id.* at 251-52.

173. *See generally* SANTOS, *supra* note 158 (comparing the three prevailing cor-

cial banks to choose their corporate model, though there is an inherent preference for the universal bank.¹⁷⁴ With its proposed financial reform legislation, the United States resists the European Union's liberal approach, opting instead to impose the familiar holding company structure upon American banks.¹⁷⁵ While the holding company structure has supporters,¹⁷⁶ the justifications for selecting this corporate model are questionable and, arguably, reflect the agencies' self interests, rather than an analysis of which corporate structure would best suit the reformed financial marketplace.¹⁷⁷ Moreover, the holding company structure is now foreign to every other banking system in

porate structures for banks: (1) the universal bank; (2) the bank with a securities subsidiary; and (3) the holding company with a banking subsidiary and a securities subsidiary).

174. See Lewis & Pescetto, *supra* note 1, at 13 (contending that the Second Banking Directive promotes competitive deregulation because of the advantages that a country maintaining the most liberal banking system, such as the German universal banking model, may achieve within the European Union).

175. See discussion *supra* Part III; see also H.R. 10, 106th Cong. sec. 103 (1999) (amending the Bank Holding Company Act of 1956 to include the new FHC entity).

176. See Edward D. Sullivan, *Glass Steagall Update: Proposals to Modernize the Structure of the Financial Services Industry*, 112 *BANKING L.J.* 977, 993-994 (1995) (identifying the choice of corporate structure as a major issue in banking reform and contending that the holding company structure is superior to the operating subsidiary model). Sullivan argues that, although both models maintain the non-bank affiliate as a separate legal entity from the bank, the subsidiaries' positive or negative performance directly affects its parent bank's financial statements and, therefore, places a greater strain on the deposit institution than the holding company model. See *id.* Sullivan concludes that the separate affiliate concept of the holding company structure is the most viable solution in the long term and argues that it enhances competition between the industries, while the firewalls permit the commercial banks to remain safe and sound. See *id.* at 995; see also Shull & White, *supra* note 34, at 448 (indicating that Alan Greenspan and the FRB favor the holding company structure).

177. See Mattingly & Fallon, *supra* note 12, at 28 (implying that regulatory agencies may have their respective best interests in mind when choosing a corporate structure; for example, the FRB may seek to perpetuate its current ability to supervise the financial system through the continuance of the holding company structure); see also SANTOS, *supra* note 158, at 17 (stating that the corporate structure debate is so prominent because of the impact it will have on determining the regulatory agency that will oversee the securities activities).

the world, except the United States, thereby strongly implying that an alternative solution is preferable.¹⁷⁸

Ultimately, the holding company approach taken in the proposed financial reform legislation may place the United States at a disadvantage, by forcing domestic banks to compete against foreign banks that benefit from the economies of scope and cost advantages that result from the freedom to choose their corporate structure.¹⁷⁹ Consequently, the key goal of improving the competitive posture of American banks through domestic financial reform may remain out of reach if the current proposal is enacted.¹⁸⁰

B. SAFETY AND SOUNDNESS OF THE PROPOSED LEGISLATION

In addition to corporate structure problems, the proposed financial reform legislation is fraught with regulatory challenges that may threaten the safety and soundness of the banking system if not addressed before its adoption.¹⁸¹ A significant hurdle facing financial

178. See SANTOS, *supra* note 158, at 19 (emphasizing that the holding company structure is implemented only in the United States).

179. See *id.* at 7, 16 (stating that economies of scope are essential to the efficiency and success of financial conglomerates, and to universal banks in particular, and concluding that holding companies do not enjoy comparable economies of scope).

180. See *id.* at 16, 19 (explaining that in the bank-subsidiary and the holding company models, commercial banking and securities activities are carried out in legally separate entities, with different management teams and distinct capital, and that, afforded the choice, banks usually choose the operating-subsidiary or the universal bank over the holding company for corporate structure). Santos concludes that in order for banks to remain competitive in today's marketplace, they must be permitted to choose their corporate structure. See *id.* at 20-21; see also *Hearings: Statement of Eugene Ludwig, supra* note 8, at 15 (highlighting the fact that greater freedom in corporate structure has not impaired bank safety and soundness abroad and, according to foreign bank supervisors, it provides essential support from non-traditional banking activities when the traditional banking activities encounter financial stress).

181. See generally *Hearings on H.R. 10 Before the House Banking and Fin. Servs. Comm.*, 106th Cong. (1999) (prepared testimony of Ralph Nader), reprinted in *FED. NEWS SERV.*, Feb. 11, 1999 [hereinafter *Hearings: Testimony of Ralph Nader*] (pinpointing safety and soundness weaknesses in the proposed legislation and the dangers of the FRB as the lead regulator in the proposed legislation).

reform is that H.R. 10, as proposed, arguably alters risks to the deposit insurance system and the federal safety net without reorganizing and rationalizing the supervisory structure.¹⁸² Instead of revamping the currently fragmented and overlapping financial regulatory system, the proposed legislation exacerbates the problem by delegating regulation not only among six federal agencies, but also among the agencies of fifty states, as well as the District of Columbia and Puerto Rico.¹⁸³

While the proponents of this functional regulation argue that the supervisory responsibilities are streamlined under the FRB as the umbrella regulator,¹⁸⁴ the reality is that inefficiencies, conflicting interpretations of regulations, and a lack of accountability still plague the proposed regulatory system.¹⁸⁵ Even more alarming is that the agencies seem to be thwarting regulatory innovation to prevent a

182. *See id.* (mentioning the savings and loan debacle of the 1980s and the implicit promise Congress made to the American people that additional risks would not be imposed upon deposit insurance and the federal safety net without stronger regulation).

183. *See* H.R. 10, 106th Cong. sec. 111 (1999) (dividing the supervision of FHCs among the FRB, functional regulators, and state supervisory authorities); *see also Hearings: Testimony of Ralph Nader, supra* note 181 (arguing that the legislation makes the system worse by scattering responsibilities under the guise of maintaining functional regulation as if it was a "regulatory holy writ").

184. *See* Tara L. Meltzer, *Congress, Regulators Split Over Major Banking Reform Bills*, 16 BANKING POL'Y REP. 6, 8 (1997) (restating Alan Greenspan's argument that consolidated umbrella supervision by the FRB is not only feasible, but necessary to protect the nation's financial system and safety net, which is supplied by federal deposit insurance and access to monies through the FRB's discount window).

185. *See Hearings: Testimony of Ralph Nader, supra* note 181 (explaining that as it was enacted in 1913, the Federal Reserve Act permits commercial banks to choose two thirds of the board of directors of each of the twelve Federal Reserve Banks, and that the boards are filled with bankers and representatives of securities and insurance companies). The role of the Federal Reserve Bank boards is to examine and supervise holding companies and, arguably, the current system of board delegation contains inherent conflicts of interest. *See id.* Additionally, in 1994, Eugene Ludwig, former Comptroller of the Currency, candidly admitted that it is never completely clear which agency is accountable for problems resulting from faulty, overly burdensome, or late regulations. *See id.*

change that might endanger their share of the regulatory turf,¹⁸⁶ while agency insiders themselves question whether the current patchwork regulatory structure can function effectively in today's complex banking environment.¹⁸⁷

C. TRANSPARENCY, CONSUMER RIGHTS, AND PROTECTION

Finally, in addition to structural issues regarding a corporate model and supervisory responsibilities, consumer interest in this potentially monumental banking reform is of concern. Although the proposed financial reform legislation contains important disclosure requirements regarding fees and costs of financial products to help foster transparency, as well as privacy provisions,¹⁸⁸ some fear that the proposed legislation does not fully address consumers' needs in the financial services industry.¹⁸⁹ In fact, some consumer advocates argue that the proposed legislation represents no more than a victory of the industries' needs over those of consumers.¹⁹⁰

Originally, H.R. 10, as introduced and passed by the House Banking and Financial Services Committee and the House Commerce Committee,¹⁹¹ lacked provisions regarding two key consumer

186. *See id.* (concluding that strong agency opposition to regulatory reform has been successful in preventing needed change).

187. *See id.* (indicating that the former head of the General Accounting Office, Charles Bowsher, frequently asked Congress to change and coordinate the regulatory system, expressing his doubts regarding the efficacy of the system in 1993). Nader asserts that H.R. 10 proposes to pile even more responsibility upon this same regulatory system. *See id.*

188. *See* H.R. 10, 106th Cong. sec. 241 (1999) (mandating that each Federal financial regulatory authority create or revise its rules to foster consistency in the disclosure of fees and costs imposed upon customers).

189. *See generally* *Hearings on Financial Modernization and H.R. 10 Before the House Banking and Fin. Servs. Comm.*, 106th Cong. (1999) (testimony of Edmund Mierzwinski, Consumer Program Director), *reprinted in* FED. NEWS SERV., Feb. 11, 1999, [hereinafter *Hearings: Testimony of Edmund Mierzwinski*] (highlighting ways in which H.R. 10 could be modified to better address consumer needs).

190. *See id.* (summarizing Mierzwinski's view that H.R. 10 represents a triumph of special interests over communities, taxpayers, and consumers).

191. *See* H.R. 10, 106th Cong. (1999) (as passed by the House Banking and Financial Services Committee February 27, 1999); H.R. 10, 106th Cong. (1999) (as passed by the House Commerce Committee on June 15, 1999).

concerns: (1) the need to restore low-cost basic banking services;¹⁹² and (2) the need to ensure that consumer privacy is adequately protected in the marketplace. This latter issue is of particular concern to consumer advocates as captive consumers may find themselves trapped in unsolicited cross-marketing schemes within the newly proposed financial conglomerates.¹⁹³

Eventually, Congress struck a compromise and revised the proposed financial reform legislation to include provisions addressing privacy issues.¹⁹⁴ Presently, as to consumer privacy rights, H.R. 10 includes a requirement that financial institutions implement specific privacy policies and inform their customers as to how the financial institutions intend to use customers' information.¹⁹⁵ Additionally, H.R. 10 requires financial institutions to permit customers to "opt out" of having their information sold or otherwise distributed to third parties. However, H.R. 10 permits the sharing of customer information among affiliated companies without providing an "opt out," as long as the customers have been informed of the privacy policy.¹⁹⁶

Curiously enough, the European Union's Second Banking Direc-

192. See *Hearings: Testimony of Edmund Mierzwinski supra* note 189 (expressing shock at the fact that virtually every request by special industry interests were retained in the proposed legislation, whereas the sole amendment to protect consumers from increasing banking fees was deleted from H.R. 10).

193. See *Hearings: Testimony of Ralph Nader, supra* note 181 (stating that proponents of H.R. 10 have tried to sell the bill by promoting the one-stop shopping argument that the new financial conglomerates will be places where consumers can dabble in the stock market, purchase insurance products, and access a number of banking products). Nader contends that consumers are not asking for these one-stop financial shopping centers, but rather are expressing concerns about the diminishing quality of service and the growth of arbitrary services at sky-rocketing costs. See *id.* Moreover, the propaganda behind H.R. 10 covers up the risk that consumers will be entrapped in undesired and anti-competitive cross-marketing promotions, with little protection of personal privacy. See *id.*

194. See H.R. 10, 106th Cong. (1999) (as passed by the full House of Representatives on July 1, 1999) (including Title V, which sets forth measures to protect nonpublic personal information of customers of financial conglomerates).

195. See *id.*

196. See *id.* at tit. IV. By contrast, the Senate version of financial reform legislation, which was passed by the Senate Banking Committee on May 6, 1999, contains no limits on the sharing of customer information. See S.900, 106th Cong. (1999).

tive mentions consumers generally in its preamble,¹⁹⁷ however, it does not contain provisions extensively addressing consumer issues. This omission is most likely due to the fact that some consumer needs are simply incompatible with the underlying rationale for banking reform, notably the banking industry's desire to achieve greater efficiencies among financial affiliates.¹⁹⁸ In effect, the European Union has chosen to address consumer privacy issues in separate legislation rather than in its Second Banking Directive.

As for domestic financial reform legislation, while provisions have been added to H.R. 10 addressing various privacy issues, some congressional officials have expressed their desire to deal with those issues in separate legislation. In sum, although Congress seems to strike a compromise in H.R. 10 between protecting consumers and permitting financial conglomerates to engage in cross-marketing within the same corporate entity, consumer privacy will remain an important topic of discussion before financial reform legislation is enacted and may ultimately prove to be a major obstacle for Congress in its push for change in the banking industry.

V. RECOMMENDATIONS

Although inherent problems exist in the current movement for domestic financial reform,¹⁹⁹ Congress should not allow these problems to break the momentum for change. In providing recommendations to Congress on financial reform, it is imperative to recall the gamut of parties implicated by this deregulatory movement, which

197. See Second Banking Directive, *supra* note 28, at pmb1. (citing the protection of consumers and investors as a purpose of the directive).

198. See *NAII Expressed Support for H.R. 10; Recommends Minor Changes*, U.S. NEWSWIRE, Feb. 10, 1999 (expressing the insurance industry's support of the proposed H.R. 10 and stating that the insurance industry is not troubled by the idea of increased competition as banks enter the insurance business). The insurance industry views banks as prospective business partners that will generate new cross-marketing opportunities. See *id.* The insurance industry also believes that this cross-marketing ability will lead to more competition in insurance markets and, ultimately, the customers will be able to access a wider array of services at the lowest prices possible. See *id.*

199. See discussion *supra* Part IV (identifying three problems currently confronting American banking reform).

runs from the insurance, securities, and banking industries, to the regulatory agencies, to the actual consumers.²⁰⁰ This wide range of parties adds to the difficulty of reaching an agreement for change that satisfies all groups affected in the financial services industry.²⁰¹ Nonetheless, reform must be achieved and several recommendations are set forth below regarding how Congress might address the current problems existing in the proposed financial reform legislation or future legislation.

A. ADDING FLEXIBILITY IN THE CHOICE OF CORPORATE STRUCTURE

The provisions of the proposed legislation require American commercial banks seeking to affiliate with securities firms to adopt a holding company organizational structure.²⁰² While Congress has accepted the FHC model in H.R. 10, this corporate structure prevails only in the United States.²⁰³ In European countries, where banks enjoy more leeway to choose their own corporate structure for operating their securities and banking activities, securities activities are usually conducted in-house²⁰⁴ or in a subsidiary of the bank.²⁰⁵ Although the current trend in American banking reform has been to

200. See Mattingly & Fallon, *supra* note 12, at 25-26 (identifying and discussing the numerous parties involved in the on-going debate on financial modernization).

201. See *id.* (explaining that although the key players directly affected by the debate on how to achieve financial modernization all agree that the current system must be revamped, their divergent and often conflicting interests have contributed to Congress' great difficulty over the past several years in attempting to craft reform legislation that accommodates all interested parties).

202. See H.R. 10, 106th Cong. sec. 103 (1999) (permitting securities firms and commercial banks to affiliate within a FHC corporate structure).

203. See SANTOS, *supra* note 158, at 19 (indicating that the holding company structure is implemented uniquely by the United States' financial services industry, and concluding that this structure is the least preferable corporate structure for a bank seeking to integrate securities activities in the most efficient and competitive manner possible).

204. See *id.* (noting that Germany, Italy, the Netherlands, and Switzerland all conduct their banking and securities activities within the same corporate entity).

205. See *id.* (commenting that banks in the United Kingdom conduct their securities activities in a subsidiary of the bank).

conclude that the moral hazard introduced by the safety net of FDIC insurance justifies a regulation mandating banks to adopt a specific organizational form,²⁰⁶ historical evidence and international postures indicate the contrary.²⁰⁷

In light of the potential gains that result from combining commercial banking with securities activities,²⁰⁸ Congress should not only permit commercial banks to engage in securities activities but also should provide them with the freedom to select their corporate structure. To achieve this end, Congress needs to revise the proposed legislation by eliminating the provision that imposes the formation of a FHC,²⁰⁹ and instead accord American banks the latitude to choose their corporate structure, like their international competitors can. Such a provision would permit American banks to choose a corporate model based upon their capitalization needs, giving them the possibility to explore the advantages of different corporate structures and, ultimately, compete more effectively with their international competitors.²¹⁰

206. See H.R. 10, 106th Cong. sec. 103 (1999) (adopting a holding company structure, arguably, based upon the rationale that such structure best protects the FDIC's federal safety net); see also SANTOS, *supra* note 158, at 20-21 (arguing that the United States erred in assuming that the moral hazard introduced by the federal safety net warranted the Glass Steagall Act, a regulation that prohibited banks from engaging in the securities business, and, additionally, that such moral hazard does not justify the current American trend to impose a particular organizational structure on commercial banks and securities firms seeking to affiliate).

207. See SANTOS, *supra* note 158, at 21 (concluding an international review of commercial banks in the securities business by stating that both historical and international evidence demonstrate that there is no reason to preclude commercial banks from conducting securities activities, or to force commercial banks to conform to a particular corporate structure when affiliating with a securities firm).

208. See LEWIS & PESCIOTTO, *supra* note 1, at 192 (noting economies of scope and enhanced economic development as benefits that result from the liberal universal banking implemented by the European Union's Second Banking Directive); see also SANTOS, *supra* note 158, at 20 (identifying economies of scope in the production and consumption of financial services as potential gains from the combination of traditional commercial banking and securities activities).

209. See H.R. 10, 106th Cong. sec. 103 (1999) (implementing a FHC structure in American financial reform by amending the Bank Holding Company Act of 1956 to also cover FHCs).

210. See discussion *supra* Part IV.A (discussing the FHC corporate structure

B. REFORMING THE SUPERVISORY STRUCTURE

In addition to imposing a corporate structure, the current financial reform legislation deregulates the banking landscape in the United States without adequately coordinating and enhancing the supervisory structure to ensure the future safety and soundness of the new system.²¹¹ When the European Union undertook the challenge of reforming its banking laws, it placed great emphasis on coordinating its supervisory structure.²¹² Ultimately, the European Union opted for a conservative safety net under its Second Banking Directive, by requiring minimum standards and home country supervision.²¹³

While the European Union's supervisory structure is not necessarily the ideal model to follow, if Congress is intent on modernizing the nation's financial system it must also revise and coordinate its supervisory structure.²¹⁴ Designating the FRB as the umbrella regulator arguably is not the solution, because it appears to be no more than an extension of a flawed and outdated structure.²¹⁵ Instead, Con-

that H.R. 10 imposes upon American banks and contrasting it with the European Union's Second Banking Directive, which does not mandate a particular corporate structure for commercial banks); *see also Hearings: Statement of Eugene Ludwig supra* note 8, at 15 n.5 (contending that the imposition of a holding company structure upon American banks is especially problematic given the organizational flexibility that other countries' banks enjoy and the fact that the financial services marketplace is increasingly globalized).

211. *See Hearings: Testimony of Ralph Nader, supra* note 181 (citing several inherent problems in the supervisory structure that H.R. 10 perpetuates in its financial reform under the guise of functional regulation).

212. *See LEWIS & PESCIOTTO, supra* note 1, at 12 (explaining that the implementation of the single banking license principle, which is enshrined in the Second Banking Directive, leads to the mutual recognition of Member State regulatory bodies for the list of activities set forth in the directive); *see also* Second Banking Directive, *supra* note 28, at pmbl. (identifying the coordination and harmonization of the European Union's supervisory laws as a key purpose of the directive).

213. *See* Second Banking Directive, *supra* note 28, at tit. II (discussing the harmonization of authorization conditions in the directive).

214. *See Hearings: Testimony of Ralph Nader, supra* note 181 (imploping Congress to modernize the financial industry's supervisory structure in tandem with the financial industry's restructuring and deregulation).

215. *See id.* (recognizing the irony that the strongest proponents of financial reform are fixated on the urgent need to eliminate the antiquated Glass Steagall Act

gress should explore the merits of alternative regulatory regimes.²¹⁶ Ideally, the creation of a single, coordinated agency, having exclusive responsibility over the regulation of financial service providers, would rectify the currently fragmented regulatory structure and foster greater accountability in the supervisory regime.²¹⁷ Although the task of examining viable alternatives to the present regulatory structure is a formidable one for Congress to undertake, and one that may prolong banking reform, any delay in enacting new banking legislation is infinitely preferable to dealing with the fallout of a poorly crafted and failed regulatory regime.²¹⁸

C. ADDRESSING CONSUMER NEEDS

Although consumer advocates have argued that the proposed financial reform legislation fails to adequately address consumer

of 1933, but at the same time are comfortable with the supervisory structure of the Federal Reserve Act of 1913, which is riddled with conflicts of interest, a lack of accountability, and great secrecy). Nader questions who would champion the Federal Reserve Act of 1913 as an appropriate framework for a federal regulatory agency. *See id.*

216. *See* Second Banking Directive, *supra* note 28, at pmb1. (indicating the key purpose of coordinating and harmonizing the European Union's supervisory laws and specifically addressing coordination issues in Title II of the Directive).

217. *See Hearings: Testimony of Ralph Nader, supra* note 181 (noting that over the years, bills have been proposed to form a single coordinated agency that would have complete responsibility over the regulation of the financial services industry). Nader contends that such legislation ultimately failed due to opposition from divergent parts of the financial services community, each lobbying to retain its current and predictable agency responsibilities. *See id.* The agencies have also stymied any legislation that would place their share of the regulatory territory at risk. *See id.* Nader concludes that Congress should not attempt to modernize the financial structure without also modernizing the regulatory structure. *See id.*

218. *See* WHITE, *supra* note 172, at 193 (stating that the costs of cleaning up the problems of the failed regulatory structure of thrifts in the savings and loan debacle will be enormous and that there is no way of assessing precisely how great the cost will be). White contends that it is only fair that the burden of meeting those costs be borne by the Treasury and the American public because it was their government's poor design and administration that instigated the debacle. *See id.* at 199. Moreover, there is no other logical place to rest the burden but upon the government and its constituents. *See id.* at 199-200.

needs,²¹⁹ there is no need to include additional consumer protection or privacy provisions in H.R. 10. In addressing the consumer privacy issue, it is imperative to recall that financial services companies are not alone in using consumer data. In fact, the use of consumer data is an essential practice of successful companies throughout the American economy, which strive to improve products and services for their customers.²²⁰ Accordingly, H.R. 10 sufficiently addresses consumer privacy issues by permitting them to “opt out” of having their information sold or otherwise distributed to third parties. A provision proscribing financial conglomerates from sharing consumer information among affiliates would needlessly restrict domestic financial institutions and place them at a competitive disadvantage internationally. Moreover, such a restrictive provision would most likely thwart the enactment of financial reform legislation altogether.

While consumer needs indisputably constitute an important concern in the financial services industry, Congress cannot adequately address such an issue as a tangent to financial services restructuring.²²¹ Rather than amending H.R. 10 to include provisions proscribing financial conglomerates from sharing information among affiliates, Congress should negotiate with consumer advocates regarding their concerns. The ideal solution would be to eliminate all consumer privacy provisions from the proposed financial reform legislation and to find a different and more appropriate forum to address consumer issues, such as through alternative legislation.²²²

219. See *Hearings: Testimony of Ralph Nader, supra* note 181 (stating that H.R. 10 tilts overwhelmingly in favor of financial corporations and proposes that Congress amend the legislation to include a provision permitting the enclosure of notices from consumer associations in billings and other mailings of financial institutions, so that the consumers' voices can be heard).

220. See *Hearings: Chaired by Jim Leach, supra* note 171 (arguing that the use of consumer information is imperative in developing new products and services for consumers in all types of businesses in the United States).

221. See *id.* (emphasizing that the privacy issue is at an embryonic phase and that Congress should not strive to resolve this issue as a sidebar to financial reform).

222. See *id.* (providing the testimony of John McCoy, President and CEO of Bank One Corporation, in which he states that the banking industry is already subject to expansive privacy regulations, unlike any other industry, and that Congress has mandated its compliance with numerous privacy laws over the past thirty

CONCLUSION

The need to reform domestic banking laws is no longer the question — the Glass Steagall Act must, and most likely will, be dismantled in the near future. The real issue, however, is how to achieve this vital reform. With its currently proposed financial reform legislation, the United States has shied away from the more revolutionary changes embodied in the European Union's Second Banking Directive. Instead, the United States clings to remnants of this country's idiosyncratic regulatory past.

If this year's financial reform legislation is not enacted, Congress will undoubtedly reintroduce similar reform legislation in the upcoming year because the need for reform will not subside. Either way, before Congress makes a definitive decision regarding legislation to revamp the nation's financial services industry, whether in the immediate or distant future, it should carefully analyze why the European Union's Second Banking Directive has been so successful. In addition, Congress should reconsider imposing the FHC corporate model on the American financial services industry and the retention of the currently fragmented supervisory structure. Such reflection is required if Congress is to implement the solution American banks truly need to launch them into the twenty-first century.