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## A NEW PARADIGM FOR FINANCIAL REGULATION: GETTING FROM HERE TO THERE\*

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*"We decide what business we want to be in, and then we get around the laws."*

*—Words of a Senior Vice President for  
Strategic Planning at a major  
money-center bank.<sup>1</sup>*

### I. INTRODUCTION

This Article provides a framework for developing a new regulatory paradigm for the financial services industry. After introductory comments about the obsolescence of the current regulatory system, it briefly explores the historical development of such significant regulatory themes as the dual banking system, multiple federal regulators, the separation of commercial and investment banking, restrictions on interstate banking, and the special character of banks. Next, following a review of previous attempts to restructure financial regulation, it concludes that the creation of a new regulatory paradigm has become necessary, and

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1. *The Brave New World of Superbanks*, NEWSWEEK, July 18, 1983, at 61 [hereinafter cited as *The Brave New World*].

suggests that the process of paradigm-building must begin with an identification of desirable regulatory goals. Finally, the Article proposes that the most appropriate means for achieving these goals would be through consistent regulation of similar financial functions regardless of institutional type.

## II. AN OBSOLETE REGULATORY SYSTEM

The financial marketplace<sup>2</sup> is governed by a regulatory system that

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2. In using the term "financial marketplace," we refer to the mechanisms for accumulating and allocating savings in the capital markets, the stock and commodities exchanges, commercial banks, savings and loan associations, savings banks, credit unions, investment companies, securities firms, and insurance companies. We shall speak of "financial institutions," "financial intermediaries," and the provision of "financial services." Some observers have drawn careful distinctions between "financial enterprises" (institutions) and "financial intermediaries." See Clark, *The Federal Income Taxation of Financial Intermediaries*, 84 YALE L.J. 1605, 1605 n.1 (1975). Clark cites R. GOLDSMITH, *FINANCIAL INTERMEDIARIES IN THE AMERICAN ECONOMY SINCE 1900*, at 50-51 (1958), who states that "financial enterprises . . . [include] all economic units . . . that are primarily engaged in the holding of and trading in intangible assets (claims and equities)." Clark notes that intermediation is simply "the process whereby savings are channeled to investors through intermediaries rather than directly." Clark, *supra*, at 1605 n.2.

Since we are concerned with other functions as well as intermediation, we shall use the term "financial institution" unless the context clearly focuses on the intermediation function. Likewise the term "financial services" will refer to delivery of products and performance of functions generally associated with financial institutions.

Admittedly, the descriptive terminology for the various types of participants in the financial marketplace has not matured to precise use and some words would seem to be used interchangeably depending upon the source. Consider, for example, the following excerpt from a 1982 U.S. Government publication which provides an alternative way of describing the financial marketplace in terms of the participants and the functions performed.

[F]inancial institutions and nonfinancial institutions [together] make up our economic universe. The major distinction between the two is that the bulk of the assets of nonfinancial [institutions] is in the form of real assets, such as plant, equipment, and inventories of goods, while most of the assets of financial [institutions] take the form of paper claims.

Financial [institutions] can, in turn, be divided into financial intermediaries and firms engaged in direct financing. Financial intermediaries are firms that place themselves between ultimate lenders and ultimate borrowers by purchasing the primary securities of the latter and issuing claims against themselves for the portfolios of ultimate lenders. Direct financing involves the marketing of primary securities in such forms as stocks, bonds, and mortgages to those desiring to purchase such securities. The principal direct financing institutions are brokerage firms and investment [banking firms].

Financial intermediaries can further be divided into depository and non-depository institutions. The four kinds of depository intermediaries are commercial banks, mutual savings banks, savings and loan associations, and credit unions. Non-depository financial intermediaries consist of contractual savings institutions, on the one hand, and other financial intermediaries on the other. Of the contractual savings institutions, the most important are life insurance companies, casualty insurance companies, private pension funds, and government pension funds. The remaining intermediaries include finance companies and mutual funds (or invest-

developed largely in response to particular historical needs. Increasingly, this system has failed to provide intelligent and uniform administration of the statutes that affect financial institutions and functions. Although its causes, extent, and cure are sources of disagreement, regulatory obsolescence is acknowledged by representatives of most traditional financial institutions—commercial banks, investment companies, and insurance companies—as well as by representatives of the regulatory agencies responsible for the supervision of such institutions.<sup>3</sup> One recent report noted that “[t]he depression-era system of regulation that was established in response to a particular set of historic conditions no longer meets the needs of the public and has resulted in a highly fragmented and antiquated banking system.”<sup>4</sup> Another report stated that “[t]he revolution occurring in the financial services market is rapidly escalating while the regulated institutions, particularly banks and bank holding companies, remain fettered by a burdensome regulatory structure.”<sup>5</sup> In introducing proposed reform legislation, Senator William

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ment companies), of which the most rapidly growing component has been money market funds.

J. ALLEN, *THE CHANGING WORLD OF FINANCIAL INTERMEDIARIES AND RELATED INSTITUTIONS: SURVEY OF MAJOR DEVELOPMENTS AND THEIR IMPLICATIONS FOR PUBLIC POLICY* (CRS Rep. No. 82-210E, Dec. 30, 1982) (on file with the *Maryland Law Review*).

3. See, e.g., Letter from Investment Company Institute to Task Group on Regulation of Financial Services (Bush Task Group) (Apr. 4, 1983) (“[T]he single major regulatory problem [is] the tremendous and illogical disparity, on both the federal and state levels, between the regulation of mutual funds and the regulation of all other types of pooled investment media.”); Letter from National Association of State Savings & Loan Supervisors to Bush Task Group (Apr. 1, 1983) (arguing that separation of the Federal Savings and Loan Insurance Corporation from the Federal Home Loan Bank Board is needed and state-chartered institutions should be freed from “illegal and unwarranted subordination to federal supervision”); Letter from Donald L. Rogers, President of the Association of Bank Holding Companies, to Bush Task Group (Mar. 11, 1983) (“The ability to offer [securities, insurance, and real estate services] is essential if bank holding companies are to remain viable competitors.”); Statement of American Banker’s Association Task Force on Restructuring the Federal Regulatory Agencies in Response to Bush Task Group (Apr. 4, 1983) (“Changes that increase competition among privately-owned providers of financial services and that reduce regulatory burdens that hinder the efficient provision of services will improve the financial system’s ability to meet customer needs.”).

Of course, not all financial institutions share in this assessment of regulatory obsolescence. Smaller, community financial institutions, in particular, tend to favor a continuation of present regulatory patterns. The National Association of Mutual Savings Banks, for example, has stated that “[o]n the threshold question of whether fundamental change is needed, our delegates were nearly unanimous that no basic change is necessary at this time.” Letter from Herbert W. Gray, Chairman of the National Association of Mutual Savings Banks, to Bush Task Group (Mar. 14, 1983).

4. Skinner, Report of the Southern Regional Banking Committee to the Executive Committee of the Southern Growth Policies Board (1983) (prepared for the Eighth Annual Meeting of the National Conference on Financial Services, Apr. 6-8, 1983), *reprinted in* BANKING EXPANSION REP., May 16, 1983, at 15.

5. Recommendation of Association of Bank Holding Companies to Bush Task Group

Proxmire observed that "developments in the marketplace have out-paced the creaky regulatory structure that was established for financial institutions during the Civil War, the money panics of the turn of the century, and the Great Depression."<sup>6</sup>

### A. *Where We Came From*

The shape of present financial institutions and their regulatory agencies is a consequence of the vicissitudes of past economic conditions, intermittent financial panics, and a constantly changing political climate.<sup>7</sup> While changes in financial services regulation have not always occurred in logical or measured sequence, five basic themes—dual banking, multiple regulators, the separation of commercial from investment banking, restrictions on interstate banking, and the "special" character of commercial banks—consistently have pervaded debates about regulatory structure.

1. *Dual Banking System.*—The early history of financial services regulation in the United States is, to a large degree, the history of bank regulation. Perhaps the single most significant theme of bank regulation has been the co-existence of state and federal regulators with sometimes overlapping jurisdictions. The development of a dual banking system, however, was not the result of any conscious program for shared power between national and state regulators.<sup>8</sup> To the contrary, it was a product of the tension between attempts by federal authorities to exert a measure of control over the banking system and the steadfast resistance to such control by state and regional interests.

Such conflicts between parochial economic interests—federal vs. state, aristocratic vs. democratic, capitalist vs. agrarian, mercantile vs. laissez-faire—have been abundant since the early days of the United States financial services industry, when the desirability and constitutionality of establishing a Bank of the United States were vigorously debated political issues.<sup>9</sup> The Jeffersonian party opposed the establishment of a

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(Mar. 1983) (attached to Letter from Donald L. Rogers, President of the Association of Bank Holding Companies, to Bush Task Group (Mar. 11, 1983)).

6. 129 CONG. REC. S1515 (daily ed. Feb. 23, 1983) (statement of Sen. Proxmire introducing S. 559, the Federal Bank Commission Act of 1983).

7. For an interesting general discussion of traumatic changes in the financial marketplace, see C. KINDLEBERGER, *MANIAS, PANICS, AND CRASHES: A HISTORY OF FINANCIAL CRISES* (1978).

8. Hackley, *Our Baffling Banking System*, 52 VA. L. REV. 565, 570-71 (1966).

9. See, e.g., R. CATTERALL, *THE SECOND BANK OF THE UNITED STATES* 164-85 (1902 new impression 1960); P. STUDENSKI & H. KROOSS, *FINANCIAL HISTORY OF THE UNITED STATES* 45, 65 (1963).

federal bank, arguing that the power to create a bank was not an enumerated power of the federal government under the Constitution.<sup>10</sup> Alexander Hamilton argued that the federal government had an implied power to establish a bank that would facilitate the performance of governmental functions.<sup>11</sup> The subsequent debate over Hamilton's proposal to establish a Bank of the United States focused on the proper roles of the federal and state governments<sup>12</sup> and anticipated many of the issues which have since accompanied the development of the dual banking system.<sup>13</sup>

The debate over establishing a federal bank was temporarily mooted in 1791 when Congress granted a twenty-year charter to the first Bank of the United States.<sup>14</sup> The record of the first Bank of the United States from 1791 to 1811 was excellent,<sup>15</sup> and the initial experiment was considered successful. Many individuals remained opposed to a federal bank, however, and when the charter expired in 1811, congressional support for its renewal was insufficient. The directors of the bank were politically inept,<sup>16</sup> and the vote to renew the charter was lost by a margin of only one vote in each house.<sup>17</sup>

With the first Bank of the United States out of business, there was a rapid expansion of state-chartered banks<sup>18</sup> which were needed to help finance the War of 1812. The financial demands of that war, the sporadic issuance of state bank notes that were not adequately backed by specie, and the war-related disruption of foreign trade<sup>19</sup> left the post-war national economy with intermittent price inflation and deflation, disrupted banking facilities, and a disordered currency.<sup>20</sup> Moreover, due

10. P. STUDENSKI & H. KROOSS, *supra* note 9, at 60.

11. Hamilton argued that a national bank would serve a number of important purposes. First, it would augment the active or productive capital of the country because "[g]old and silver . . . when deposited in banks, to become the basis of a paper circulation . . . acquire . . . an active and productive quality." Second, it would provide "[g]reater facility to the Government, in obtaining pecuniary aids, especially in sudden emergencies." Third, it would facilitate the payment of taxes through the availability of loans. A. Hamilton, Treasury Report on a National Bank (1790), *reprinted in* 9 AMERICAN STATE PAPERS, Finance Vol. 1, 67-68 (1832).

12. E. REED, R. COTTER, E. GILL & R. SMITH, COMMERCIAL BANKING 18 (2d ed. 1980) [hereinafter cited as COMMERCIAL BANKING].

13. P. STUDENSKI & H. KROOSS, *supra* note 9, at 60-61.

14. Act of Feb. 25, 1791, ch. 10, 1 Stat. 191.

15. B. HAMMOND, BANKS AND POLITICS IN AMERICA FROM THE REVOLUTION TO THE CIVIL WAR 209 (1957).

16. *Id.* at 222.

17. *Id.*

18. COMMERCIAL BANKING, *supra* note 12, at 18.

19. B. HAMMOND, *supra* note 15, at 227-29.

20. P. STUDENSKI & H. KROOSS, *supra* note 9, at 82.

to the largely uncontrolled proliferation of state banks, the varieties of "currency" from bank to bank and from state to state created confusion and uncertainty which generally impeded interstate commerce.

In 1816, Congress responded to the need to restore order in the banking and currency system and to return to specie payments<sup>21</sup> by granting a twenty-year charter for the second Bank of the United States.<sup>22</sup> The second Bank of the United States was subject to much of the same opposition that had confronted its predecessor. In 1819<sup>23</sup> and again in 1824,<sup>24</sup> the Supreme Court was asked to rule on the constitutionality of a federal bank. Each time, Chief Justice Marshall wrote for the Court to uphold the Bank's constitutionality.<sup>25</sup> Even after thwarting constitutional attacks, however, and despite congressional support for its existence, the desirability of a federal bank remained a contentious political issue. After President Andrew Jackson in 1832 vetoed the legislation to renew its charter,<sup>26</sup> the second Bank of the United States went out of existence in 1836.<sup>27</sup>

With the demise of the second Bank of the United States, and the absence of national banks during the ensuing twenty-seven years, state banking entered its second era of great growth.<sup>28</sup> State governments favored the formation of banks to stimulate industry and to provide sources of public financing.<sup>29</sup> In 1837, in *Briscoe v. Bank of Kentucky*,<sup>30</sup> the Supreme Court confirmed that states had the right to charter banks, and upheld the authority of the Commonwealth of Kentucky to create,

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21. *Id.* at 83-84.

22. Act of Apr. 10, 1816, ch. 44, 3 Stat. 266; *see generally* J. HURST, A LEGAL HISTORY OF MONEY IN THE UNITED STATES, 1774-1970, at 145-51 (1973).

23. *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 159 (1819).

24. *Osborn v. Bank of the United States*, 22 U.S. (9 Wheat.) 326 (1824).

25. In *McCulloch*, the Court relied upon the necessary and proper clause and upon Congress's constitutionally conferred powers to declare war and raise revenue. 17 U.S. (4 Wheat.) at 162-63. In *Osborn*, the Court reviewed and affirmed *McCulloch*, noting that the Bank "is an instrument which is 'necessary and proper' for carrying on the fiscal operations of government." 22 U.S. (9 Wheat.) at 379.

26. P. STUDENSKI & H. KROOSS, *supra* note 9, at 105; *see generally* J. MCFAY, THE POLITICS OF JACKSONIAN FINANCE (1972) (discussing the political climate in Washington and the banking industry during Andrew Jackson's presidency).

27. *See generally* II MESSAGES AND PAPERS OF THE PRESIDENTS 576-89 (D. Richardson ed. 1897) (containing the text of President Andrew Jackson's veto message); R. CATTERALL, *supra* note 9 (an engaging historical account of the second Bank from its establishment to its defeat); B. HAMMOND, *supra* note 15, at 144-450 (containing a detailed discussion of the two Banks of the United States); R. HOFSTADTER, THE AMERICAN POLITICAL TRADITION AND THE MEN WHO MADE IT 56-63 (1948) (discussing the political factors leading to the demise of the second Bank of the United States).

28. P. STUDENSKI & H. KROOSS, *supra* note 9, at 107.

29. *Id.*

30. 36 U.S. (11 Pet.) 256 (1837).

as its exclusive property, the Bank of the Commonwealth of Kentucky with the authority to issue bank notes as currency.<sup>31</sup>

In this environment, with the second Bank of the United States out of existence, the constitutionality of state-chartered banks confirmed, and the use of state banks on the rise,<sup>32</sup> the concept of "free banking" became popular as a "proper solution to the difficult banking problems of the 1830's."<sup>33</sup> The business of banking was to be open to all market participants who wished to compete. Competition, not governmental intervention, would regulate the financial marketplace.

Although a pure free banking system was never adopted in the United States, New York in 1838 enacted a Free Banking Act<sup>34</sup> which was copied by other states, and such state legislation contributed to the rapid expansion of state banking between 1836 and 1863. During these years of so-called "wildcat" banking there was no federal paper currency, state laws were lax, and the banks created under them did little to inspire public confidence.<sup>35</sup> The growth of state banks was accompanied in too many instances by unsound banking practices and the excessive issuance of bank notes.<sup>36</sup> Many of these state banks were owned and operated by entrepreneurs who had an eye for short-term profit but lacked an understanding of banking, economics, or finance.<sup>37</sup> Moreover, as the Civil War approached, the federal government found itself with no central bank to act as its fiscal agent.<sup>38</sup>

Congress in 1863 responded to the banking situation by passing the National Currency Act,<sup>39</sup> which was enacted both to finance the Civil

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31. *Id. passim*.

The opinion in *Briscoe* was tempered, however, by Justice Story's dissent. He cautioned that states could create banks and authorize them to issue bank notes as currency but "subject always to the control of Congress, whose powers extend to the entire regulation of the currency of the country." *Id.* at 348 (Story, J., dissenting).

32. Klebaner, *State-Chartered American Commercial Banks 1781-1801*, 53 *BUS. HIST. REV.* 529 (1979).

33. F. REDLICH, *THE MOLDING OF AMERICAN BANKING: MEN AND IDEAS* (pt. 2) at 187 (1951 & photo. reprint 1968).

34. B. HAMMOND, *supra* note 15, at 583-84.

35. *See* Hackley, *supra* note 8, at 570; *see generally* Hammond, *Historical Introduction*, in *BANKING STUDIES* 9-10 (1941) (in some states banking was a prohibited activity at various times during the 1840's and 1850's).

36. *COMMERCIAL BANKING*, *supra* note 12, at 19.

37. *See* P. STUDENSKI & H. KROOSS, *supra* note 9, at 73-74.

38. *Id.* at 137.

39. Act of Feb. 25, 1863, ch. 58, 12 Stat. 665. President Lincoln had recommended the establishment of a "uniform currency" to be provided by banking associations organized under a "general act" of the Congress. *See* STAFF OF SENATE COMM. ON BANKING AND CURRENCY, 88TH CONG., 1ST SESS., *FEDERAL BANKING LAWS AND REPORTS: A COMPILATION OF MAJOR FEDERAL BANKING DOCUMENTS 1780-1912*, at 306 (Comm. Print 1963).



War effort by stimulating the sale of government securities<sup>40</sup> and to promote a uniform currency. The National Currency Act provided for the organization of national banks which would possess the authority to issue bank notes secured by government bonds. It also established a separate bureau within the Department of the Treasury, under a Comptroller of the Currency, which was given authority to approve the formation of national banks.<sup>41</sup> Subsequently, the National Currency Act was replaced by legislation which has since become known as the National Bank Act of 1864 (National Bank Act).<sup>42</sup> Although it is often considered to be a fundamental component of the dual banking system,<sup>43</sup> the National Bank Act was intended, at least in part, to hasten the demise of state banking.<sup>44</sup>

In 1865, in a further effort to reduce the number of state banks,<sup>45</sup> Congress passed a ten percent per annum tax on state bank notes.<sup>46</sup> The Supreme Court upheld the constitutionality of the tax in 1869.<sup>47</sup> The tax's impact upon state banks, however, was not as great as expected. In a classic market response to regulation, deposit banking and the use of checks as an alternative to bank notes became widespread.<sup>48</sup> Moreover, many banks still preferred to operate under state charters because state regulation was generally less restrictive than federal regulation.

2. *Competing Federal Regulatory Agencies.*—The interagency competition and the potential for chaos inherent in the dual banking system have been compounded by the existence of multiple regulators at the federal level. In 1908, following the financial "panic" of 1907, a National Monetary Commission studied the need for revising mandatory reserve requirements for commercial banks as well as the need for a more elastic

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40. Hackley, *supra* note 8, at 570.

41. Act of Feb. 25, 1863, ch. 58, 12 Stat. 665.

42. Act of June 3, 1864, ch. 106, 13 Stat. 99. The legislation was entitled "An Act to Provide a National Currency, Secured by a Pledge of United States Bonds and to Provide for the Circulation and Redemption Thereof." For discussion on the codification of the provisions of the National Bank Act that have survived to the present, see Levin, *In Search of the National Bank Act*, 97 BANKING L.J. 741, 743, 750 n.26 (1980).

43. At least one federal circuit court has exhibited this confusion. In *Independent Bankers Ass'n of Am. v. Smith*, 534 F.2d 921, 932 (D.C. Cir.), *cert. denied*, 429 U.S. 862 (1976), the circuit court observed that "[w]hen Congress established our dual banking system it wisely placed at one cornerstone the principle of competitive equality between state and national banks."

44. See CONG. GLOBE, 38th Cong., 2d Sess. 1139 (1865).

45. Hackley, *supra* note 8, at 573.

46. Act of Mar. 3, 1865, ch. 78, § 6, 13 Stat. 469, 484.

47. *Veazie Bank v. Fenno*, 75 U.S. (8 Wall.) 533 (1869).

48. See generally J. HURST, *supra* note 22, at 50-53 (discussing the increased use of bank deposits and checks as a source of greater liquidity).

currency.<sup>49</sup> Initially, the National Monetary Commission favored establishing a central banking institution,<sup>50</sup> but there was little political support for such an approach. Later, a compromise was reached which called for establishing eight to twelve regional Federal Reserve Banks that were to operate under the general supervision of the Board of Governors of the Federal Reserve System (Federal Reserve Board).<sup>51</sup> Membership in the Federal Reserve System was mandatory for all nationally-chartered banks and elective for state-chartered banks. Members were required to buy stock in a regional reserve bank and submit to its regulation.<sup>52</sup> Consequently, all nationally-chartered banks were subject to regulation by both the Comptroller of the Currency and the Federal Reserve Board.

State banks were permitted to join the Federal Reserve System while still retaining their state charters as long as they met minimum capital and reserve requirements.<sup>53</sup> Membership brought with it regulation by the Federal Reserve System as well as by the state regulator. Alternatively, state banks could choose to forego the benefits of membership and remain free of federal supervision altogether.

The next significant step in the evolution of overlapping state and federal jurisdiction was the creation of the Federal Deposit Insurance Corporation (FDIC),<sup>54</sup> the third major component of the federal regulatory structure. Under the terms of the Vandenberg Amendment to the Banking Act of 1933,<sup>55</sup> all banks that were members of the Federal Reserve System were required to have their deposits insured by the FDIC; non-member banks could receive insurance coverage upon application to and approval by the FDIC. The 1933 legislation was temporary, but the federal deposit insurance system was adopted permanently in 1935.<sup>56</sup> As Friedman and Schwartz have observed, the Banking Act of 1933 "neither abolished nor reduced the powers of any existing government body concerned with banking."<sup>57</sup> Rather, "it simply superimposed an additional agency, the FDIC, whose functions both

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49. Hackley, *supra* note 8, at 573.

50. P. STUDENSKI & H. KROOSS, *supra* note 9, at 254-55.

51. J. HURST, *supra* note 23, at 206.

52. Federal Reserve Act, ch. 6, § 2, 38 Stat. 251, 252 (1913); *see also* Hackley, *supra* note 8, at 574.

53. HOUSE COMM. ON BANKING AND CURRENCY, CHANGES IN THE BANKING AND CURRENCY SYSTEM OF THE UNITED STATES, H.R. REP. NO. 69, 63d Cong., 1st Sess. 42 (1913).

54. The FDIC was created by the Vandenberg Amendment to the Banking Act of 1933, ch. 89, § 8, 48 Stat. 168 (codified as amended at 12 U.S.C. §§ 1811-1832 (1982)).

55. *Id.*

56. M. FRIEDMAN & A. SCHWARTZ, A MONETARY HISTORY OF THE UNITED STATES 1867-1960, at 434-35 (1963).

57. *Id.* at 435.

supplemented and duplicated those of existing agencies."<sup>58</sup> Moreover, the federal deposit insurance system provided an incentive for state-chartered non-member banks to submit to the federal regulatory control of the FDIC. By the end of 1982 the FDIC had become the primary regulator for 8833 state-chartered non-member banks.<sup>59</sup>

In the 1930's, the power of the Federal Reserve System grew, extending to administration of the restrictions governing securities activities by banks, to enforcement of deposit interest rate controls, and in 1956, to the regulation of bank holding companies. Congress, in the 1930's, also began to expand federal control of other segments of the financial services industry. The Securities and Exchange Commission (SEC) was created in 1934 to regulate activities traditionally associated with investment banking and securities brokerage.<sup>60</sup> The Federal Home Loan Bank Board (FHLBB) was established in 1932 to supervise the savings and loan industry and facilitate home mortgage financing.<sup>61</sup> More recently, the National Credit Union Administration (NCUA) was established in 1970<sup>62</sup> and the Commodity Futures Trading Commission (CFTC) was established in 1974.<sup>63</sup> Even in the area of insurance, an industry for the most part regulated at the state level,<sup>64</sup> Congress in 1974 extended federal regulation to insured pension plans through the Employee Retirement Income Security Act (ERISA) and the creation of the Pension Benefit Guaranty Corporation (PBGC).<sup>65</sup>

*3. The Separation of Commercial Banking from Certain Securities Activities.*—The banking system that developed in the United States in the nineteenth century was based upon the British tradition of separation of commercial and investment banking functions and was influenced by

58. *Id.*

59. FEDERAL DEPOSIT INSURANCE CORPORATION, 1982 STATISTICS ON BANKING 6 (statistics provided as of December 31, 1982).

60. The SEC was established by the Securities Exchange Act of 1934, ch. 404, § 4, 48 Stat. 885 (codified as amended at 15 U.S.C. § 78(d) (1982)).

61. The FHLBB was established by the Federal Home Loan Bank Act of 1932, ch. 522, 47 Stat. 725 (codified as amended at 12 U.S.C. §§ 1421-1449 (1982)); see generally T. MARVELL, THE FEDERAL HOME LOAN BANK BOARD (1969).

62. The NCUA was established in 1970. Act of Mar. 10, 1970, Pub. L. No. 91-206, 84 Stat. 49 (1970).

63. The CFTC was established in 1974 by the Commodity Exchange Act, Pub. L. No. 93-463, 88 Stat. 1389 (1974) (codified as amended in scattered sections of 5 and 7 U.S.C. (1982)).

64. McCarran-Ferguson Act, 15 U.S.C. §§ 1011-1015 (1982); SEC v. Variable Annuity Ins. Co., 359 U.S. 65, 68-69 (1959). *But cf.* United States v. South-Eastern Underwriters Ass'n, 322 U.S. 533, 552-53 (1944) (the interstate activities of insurance enterprises are subject to Congress' control under the commerce clause).

65. The PBGC was established by the Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, tit. IV, § 4002, 88 Stat. 829, 1004 (codified as amended at 29 U.S.C. § 1302 (1982)).

the belief that public deposits should not be committed to investment banking, which was considered to be inherently speculative and risky.<sup>66</sup> Section 8 of the National Bank Act expressed this philosophy by not including investment banking among the enumerated powers of national banks.<sup>67</sup>

At least in part because of competitive pressures from state banks during the 1860's and 1870's, however, courts initially adopted a permissive interpretation of the National Bank Act. For example, the phrase "by discounting and negotiating promissory notes" was interpreted to include an implied power of national banks to invest in state, municipal, and corporate bonds.<sup>68</sup> The limits of judicial permissiveness were not defined clearly until *First National Bank of Charlotte v. National Exchange Bank of Baltimore*,<sup>69</sup> in which the Supreme Court stated that the prohibition on stock trading contained in the National Bank Act prevented national banks from investing in corporate securities and stock for profit.<sup>70</sup> In contrast, state-chartered banks and trust companies were generally permitted to engage in investment banking activities. Trust companies, in particular, enjoyed rather broad securities powers under state charters.<sup>71</sup>

Other securities activities of national banks were similarly curtailed in the early twentieth century. In 1902, the Comptroller of the Currency concluded that the National Bank Act did not permit national banks to participate in the underwriting and distribution of equity securities.<sup>72</sup>

66. Perkins, *The Divorce of Commercial and Investment Banking: A History*, 88 BANKING L.J. 484, 485 (1971). For a comprehensive discussion of historical and current issues in the area of separation of commercial banking from investment banking, see generally H. Pitt & J. Williams, *The Evolving Financial Services Industry: Statutory and Regulatory Framework and Current Issues in the Banking Securities Arena* (outline prepared for the American Bar Association National Institute on Financial Institutions: An Assessment of the New Products, Structure, Marketing and Regulation, Boston, Massachusetts, Apr. 27-28, 1983).

67. The National Bank Act of 1864 included the following list of powers for national banks:

[A]ll such incidental powers as shall be necessary to carry on the business of banking by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidence of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; [and] by obtaining, issuing, and circulating notes according to the provisions of this act.

Act of June 3, 1864, ch. 106, § 88, 13 Stat. 99, 101.

68. See, e.g., *First Nat'l Bank v. Bennington*, 9 F. Cas. 97 (C.C.D. Vt. 1879) (No. 4807) (interpreting the clause in the National Bank Act, "by discounting and negotiating promissory notes," to include investing in municipal bonds); *Newport Nat'l Bank v. Board of Educ.*, 114 Ky. 87, 70 S.W. 186 (1902) (same).

69. 92 U.S. 122 (1875).

70. *Id.* at 128.

71. Perkins, *supra* note 66, at 487.

72. See, e.g., F. REDLICH, *supra* note 33, at 393.

Prodded by the need to compete with full service state banks, a number of major national banks responded to the comptroller's ruling by creating nonbank securities affiliates chartered under state law. These affiliates were free from federal regulation and were able to engage in the underwriting of corporate securities.<sup>73</sup> In 1912, Congress established the Pujo Committee to investigate the involvement of commercial banks in investment banking activities.<sup>74</sup> The report of the Pujo Committee concluded that it was illegal for national banks to purchase and sell equity securities, and expressed "grave doubt [about] the power of national banks to buy and sell bonds."<sup>75</sup>

The outbreak of World War I, however, provided an opportunity for expanded national bank involvement in the distribution of securities. Many of the Liberty Bonds<sup>76</sup> issued by the federal government were sold through national banks. As a result, national banks developed efficient systems for distributing securities and enjoyed the benefits of investor confidence because Liberty Bonds were of unquestioned soundness.<sup>77</sup> At the end of World War I, the marketing systems that had so successfully distributed Liberty Bonds went searching for new products to sell.

Meanwhile, state banks were expanding their investment banking activities and the dual banking system exerted increased pressure on federal regulators. Because the federal government wished to encourage state banks and trust companies to enter the Federal Reserve System, these state-chartered institutions were allowed to become member banks without giving up the investment banking privileges granted to them by state law.<sup>78</sup> Competitive pressures then forced the Comptroller of the Currency to permit national banks to engage in modified securities activities.<sup>79</sup> The Comptroller of the Currency's Annual Report of 1924 recommended legislation permitting national banks to buy and sell se-

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73. *See id.*; *see also* H. WILLIS & J. CHAPMAN, *THE BANKING SITUATION 186-87* (1934) (describing the various securities activities of typical securities affiliates).

74. The Pujo Committee was a subcommittee of the House Committee on Banking and Currency authorized by Congress in H.R. Res. 429, 62d Cong., 2d Sess. (1912), to investigate the monetary and banking conditions in the United States with a view toward remedial legislation. The recommendations of the Pujo Committee are contained in *REPORT OF THE COMM. APPOINTED PURSUANT TO HOUSE RESOLUTIONS 429 AND 504 TO INVESTIGATE THE CONCENTRATION OF CONTROL OF MONEY AND CREDIT*, H.R. REP. NO. 1593, 62d Cong., 3d Sess. 162 (1913).

75. H.R. REP. NO. 1593, 62d Cong., 3d Sess. 152.

76. Liberty Bonds were issued by the United States in 1917, 1918, and 1919 to finance the participation of the United States in World War I and to fund loans to the Allied Powers. G. MUNN, *ENCYCLOPEDIA OF BANKING AND FINANCE* 558 (F. Garcia 8th ed. rev. 1983).

77. W. PEACH, *THE SECURITY AFFILIATES OF NATIONAL BANKS* 31-33 (1941).

78. *See* C. TIPPETTS, *STATE BANKS AND THE FEDERAL RESERVE SYSTEM* 109-12 (1929).

79. W. PEACH, *supra* note 77, at 150.

curities through affiliates.<sup>80</sup> Throughout the 1920's there was an enormous expansion in bank underwriting of corporate debt securities, and by the end of that decade the bank share of that market exceeded sixty percent.<sup>81</sup>

The presumed existing power of national banks to underwrite investment securities through affiliates was confirmed by the Pepper-McFadden Act (McFadden Act) in 1927.<sup>82</sup> The provisions of the McFadden Act that purported to ratify the securities activities of banks were not without opposition, however. Senator Carter Glass was prominent among those who contended that the proper role of banks was not to underwrite securities but was rather to allocate capital to productive uses and enterprises through commercial loans.<sup>83</sup> The collapse of the stock market in 1929, in part attributable to the startling incompetence of the Federal Reserve Board in not acting to curb speculative activity by commercial banks,<sup>84</sup> further convinced Senator Glass and others that the separation of commercial and investment banking was fundamental to the integrity of the national banking system.<sup>85</sup>

As a result of the efforts of Senator Glass and Congressman Henry Steagall, among others, Congress in 1933 adopted the Glass-Steagall Act,<sup>86</sup> which drew a wavy line between commercial banking and certain forms of investment banking. National banks were barred from underwriting and dealing in all securities except treasury securities and state and local general obligation bonds,<sup>87</sup> but retained their authority to invest in "investment grade" corporate bonds and state and local revenue

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80. COMPTROLLER OF THE CURRENCY, ANNUAL REPORT 17 (1924).

81. Perkins, *supra* note 66, at 495, 527.

82. Ch. 191, § 2(b), 44 Stat. 1224, 1227 (1927) (codified as amended at 12 U.S.C. § 378 (1982)).

83. *See Brokers' Loans: Hearings on S. Res. 113 Before the Senate Comm. on Banking and Currency*, 70th Cong., 1st Sess. (1928).

84. J. GALBRAITH, *THE GREAT CRASH 1929*, at 32-47 (1961).

85. *See* H. WILLIS & J. CHAPMAN, *supra* note 73, at 67-71 (discussing some of the considerations which led the Senate Banking Committee, under Chairman Glass, to advocate the separation of commercial and investment banking); Perkins, *supra* note 66, at 499 (quoting excerpt from *Letter of Sen. Carter Glass*, N.Y. Times, Aug. 21, 1929) ("As a purely business proposition I would like to see excessive marginal speculation [by banks] abated. . . . My concern has been for the economic integrity of the Federal Reserve banking system."). *See generally* S. Friedman & C. Barber, *Financial Markets in 1920-1933* (1981) (outline prepared for the Ninth Annual University of California, San Diego, Securities Regulation Institute) (summarizing the factors considered by legislators prior to the enactment of the Glass-Steagall Act in 1933, including the efficacy of securities affiliates of commercial banks).

86. Banking (Glass-Steagall) Act of 1933, ch. 89, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C. (1982)).

87. *Id.* § 16, 48 Stat. 162, 184 (codified as amended at 12 U.S.C. § 24 (1982)).

bonds.<sup>88</sup> Moreover, while the Act permitted banks to offer brokerage services, it did so in an obscure way;<sup>89</sup> its method of dealing with securities affiliates was pregnant with loopholes, many of which have only recently been exploited.<sup>90</sup>

4. *Restrictions on Interstate Banking.*—Commercial banking enterprises are unique among major American businesses in that, historically, they have not been permitted to engage in business in more than one state.<sup>91</sup> The foundation of this state-by-state banking system is the legal authority of each state to prohibit out-of-state institutions from operating branch banks within its territory.<sup>92</sup> Moreover, at the federal level, national banks and state member banks have been barred from interstate branching since the passage of the McFadden Act in 1927.<sup>93</sup>

The McFadden Act dealt with branch banking, but did not address the issue of bank holding companies owning separate banks in more than one state. The issue finally was addressed by the Douglas Amendment<sup>94</sup> to the Bank Holding Company Act of 1956.<sup>95</sup> Under the Douglas Amendment, states are presumed to want to exclude from their banking industries not only branches of out-of-state banks, but also in-state banks owned by any bank holding company that controls a state or national bank in another state.<sup>96</sup> Time, however, has not been kind to restrictions on interstate banking activity. During the past decade, many of the nation's largest banks have made successful efforts to establish an extensive interstate presence notwithstanding current prohibitions on interstate banking.<sup>97</sup>

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88. See generally Rogowski, *Commercial Banks and Municipal Revenue Bonds*, 95 BANKING L.J. 155 (1978).

89. Pitt & Williams, *The Glass-Steagall Act: Key Issues to the Financial Services Industry*, 11 SEC. REG. L.J. 234, 237 (1983).

90. See, e.g., *OCC Approves National Bank Charter for Trust Company Owned by Mutual Fund Adviser and Broker*, [1982-1983 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 99,463 (Feb. 2, 1983).

91. Ginsburg, *Interstate Banking*, 9 HOFSTRA L. REV. 1133, 1137 & n.1 (1981).

92. See *id.* at 1152-59.

93. Ch. 191, § 7, 44 Stat. 1224, 1228 (1927) (codified as amended at 12 U.S.C. § 36 (1982)).

94. 12 U.S.C. § 1842(d) (1982).

95. *Id.* §§ 1841-1850.

96. Ginsberg, *supra* note 91, at 1167.

97. See Brouillette, *Interstate Banking: One Thrift's Experience*, Am. Banker, Apr. 4, 1984, at 1; Carrington, *Financial Fracas: Some Bankers Step Up Drive to Win the Right to Enter New Fields*, Wall St. J., Mar. 22, 1984, at 1, col. 6 (discussing the efforts of banks to overcome restrictive regulation and enter new industries such as real estate, securities, underwriting, and insurance); Fraust, *Banks Stake Out an Interstate Future*, Am. Banker, Apr. 2, 1984, at 1 [hereinafter cited as Fraust, *Banks Stake Out an Interstate Future*]; Fraust, *Crossing State Lines: How Some Banks Did It*, Am. Banker, Apr. 3, 1984, at 1, 9 [hereinafter cited as Fraust, *Crossing State Lines*]; cf.

5. *Banks as "Special" Institutions.*—The final distinguishing characteristic of the evolution of financial institutions has been the special role accorded to banks. Over time, there has been a progressively deepening commitment by the federal government to the safety and soundness of the banking system. The creation of the FDIC,<sup>98</sup> the role of the Federal Reserve Board as the lender of last resort,<sup>99</sup> and the conviction in the marketplace that federal financial regulators would never permit a major bank to "go under"<sup>100</sup> are evidence of that commitment. Changes in the financial markets, however, have made it increasingly more difficult to decide which institutions are "banks."<sup>101</sup>

Writing for the Supreme Court in 1963, Justice Brennan in *United States v. Philadelphia National Bank*<sup>102</sup> noted the distinctive ability of banks to accept demand deposits as well as the unique role of banks in providing business credit.<sup>103</sup> In agreeing that the "cluster of products . . . and services . . . denoted by the term 'commercial banking' . . . [composed] a distinct line of commerce," the Supreme Court stated that "[s]ome commercial banking products or services [such as the checking account] are so distinctive that they are entirely free of effective competition from products or services of other financial institutions."<sup>104</sup> Since the *Philadelphia National Bank* decision, however, the term "deposit" has been more and more broadly construed and courts have determined that it no

McMurray, *Financial Fracas: Banks and Rivals Push Into New Businesses as Congress Dawdles*, Wall St. J., Mar. 23, 1984, at 1, col. 6.

98. See *supra* note 54.

99. "Under the over-all supervision of the Board of Governors, Federal Reserve Banks perform many varied functions for the banking community. Through the operation of its 'discount window,' a Reserve Bank may lend funds to member banks, and . . . other depository institutions." HOUSE COMM. ON BANKING, FINANCE AND URBAN AFFAIRS, 98TH CONG., 1ST SESS., FORMATION AND POWERS OF NATIONAL BANKING ASSOCIATIONS—A LEGAL PRIMER 1-36 (Comm. Print 1983) (prepared by Natter) (citing 12 U.S.C. § 461 (1982)). The Board of Governors has the statutory authority to "authorize any Federal reserve bank . . . to discount [eligible collateral] for any individual, partnership, or corporation." 12 U.S.C. § 343 (1982).

100. See generally *Warning Lights for Bank Soundness: Special Issue on Commercial Bank Surveillance*, ECON. REV., Nov. 1983 (published by the Federal Reserve Bank of Atlanta).

101. Some commentators still adhere to the view that banks are special and that banking and nonbanking activities are readily distinguishable for regulatory purposes. Gerald E. Corrigan, President of the Federal Reserve Bank of Minneapolis, for example, has argued that there are three unique characteristics of banks: "1. Banks offer transaction accounts; 2. Banks are the back-up source of liquidity for all other institutions; 3. Banks are the transmission belt for monetary policy." Corrigan further observes that "[i]t is clear that these essential characteristics are highly complementary and furthermore that it is the relationship among them that best captures the essence of what makes banks special." Fed. Reserve Bank of Minneapolis, *Are Banks Special?*, in ANNUAL REPORT 7 (1982).

102. 374 U.S. 321 (1963).

103. *Id.* at 326-27.

104. *Id.* at 356.



longer provides a clear line of division between banks and "nonbank banks."<sup>105</sup>

### B. *Where We Are Today*

Economic events and the shifting demands for more and different financial services have prompted innovation among the various sectors of the financial services industry. Innovation and adaptation have in turn encouraged cross-industry competition which has threatened the integrity of a regulatory structure initially based on the premise that each type of financial institution had distinct functions, operated in a distinct sector of the capital markets, and could best be served by a separate regulator. The validity of that premise was evanescent, and the structure which rested upon it has crumbled with the erosion of the foundation.<sup>106</sup>

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105. *See, e.g.*, *Independent Bankers Ass'n of Am. v. Smith*, 534 F.2d 921, 938-42 (D.C. Cir.), *cert. denied*, 429 U.S. 862 (1976) (interpreting "deposits" as including those types of transactions conducted at an "electronic teller": (1) ordinary deposits into a checking or savings account; (2) transfers of funds between two accounts; and (3) payments on installment loans or credit card accounts).

The term "nonbank bank" has been defined as:

an organization that evades the Bank Holding Company Act's two-pronged definition of a bank as an institution that both accepts demand deposits and makes commercial loans. By stripping a bank of one of those activities, a company owning such an institution may avoid the [Bank Holding Company] Act's prohibitions against nonbanking organizations controlling banks and against interstate banking, and avoid regulation by the Federal Reserve Board, which administers the [Bank Holding Company] Act.

*IBAA Assails OCC's Nonbank Policies in Letter to Reagan, Others*, 42 WASH. FIN. REP. (BNA) No. 11, at 442 (Mar. 12, 1984); *see also* *Just When Is a Bank Not a Bank? When It Is An Abomination*, *Wall St. J.*, Jan. 30, 1984, at 1, col. 4 ("What makes a bank nonbank is that it has been slightly reorganized [by eliminating either its deposit taking or commercial lending activities] by a nonbanking corporate owner to avoid Federal Reserve Board regulation.")

The Federal Reserve Board and the Comptroller of the Currency have disagreed vigorously over the comptroller's willingness to approve nonbank banks. *See, e.g.*, *Comptroller Expresses Dismay Over Penney End Run Around Moratorium*, *Am. Banker*, Apr. 29, 1983, at 1. Significant opposition to nonbank bank expansion has also been voiced by representatives of the securities and mutual funds industries. They are particularly wary of regulatory actions and legislative changes which would permit nonbank banks to enter the investment banking industry without granting investment bankers reciprocal access to compete in commercial banking activities. Testifying before the Senate Banking Committee on March 7, 1984, David Silver, President of the Investment Company Institute, recommended that the Glass-Steagall Act be restored to its "pristine purity" and said that "nonbank banks are being established not because of a weakness in Glass-Steagall but because regulators are acting like 'non-cop cops' by failing to enforce the banking laws." *Securities Investment Companies Opposed to Giving Banks New Powers*, 42 WASH. FIN. REP. (BNA) No. 11, at 431, 433 (1984).

106. *See, e.g.*, Ad Hoc Committee on Developments in Investment Services, *Homogenization of Financial Institutions: The Legislative and Regulatory Response*, 38 BUS. LAW. 241 (1982); Clark, *The Soundness of Financial Intermediaries*, 86 YALE L.J. 1 (1976); Wallison, *Banking Regulatory System Badly in Need of Reform*, *Legal Times*, June 27, 1983, at 27.

Traditionally, financial institutions have been treated as either investment institutions, insurance institutions, or depository institutions, on the assumption that each type of institution performed readily identifiable and separable functions.<sup>107</sup> In recent years, however, product lines have been blurred, institutional characterization has become less significant, and federal regulators have attempted to keep pace with an expanding "financial services industry."<sup>108</sup> Brokers and financial conglomerates have offered money market mutual funds and attracted billions of dollars in deposits from investors looking for higher interest rates than those banks could offer under federal law.<sup>109</sup> Banks provide discount brokerage services,<sup>110</sup> operate as futures commission merchants,<sup>111</sup> and have attempted to enter the insurance business.<sup>112</sup> Savings and

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107. See, e.g., Wallison, *supra* note 106, at 27.

108. See generally Carrington, *supra* note 97; McMurray, *supra* note 97; *The Brave New World*, *supra* note 1; *Financial Morass: Deregulation of Banks Stirs Confusion, Splits Fed and White House*, Wall St. J., July 1, 1983, at 1, col. 6.

109. The lifting of interest rate restrictions under the Federal Reserve Board's Regulation Q, 12 C.F.R. § 217.0 (1983), has, of course, shifted some of these funds away from money market mutual funds and into money market deposit accounts (MMDAs) and other deposit accounts offered by banks. Federal Reserve Board statistics for June 1983 indicate a total of \$367.3 billion held in MMDAs and \$178.5 billion held in money market mutual funds. *Money Stock Measures and Components*, 69 FED. RESERVE BULL. 15 (1983). In June 1982, \$202.3 billion was held in money market mutual funds. *Money Stock Measures and Components*, 68 FED. RESERVE BULL. 13 (1983). The Depository Institutions Act of 1980, 12 U.S.C. § 3501 (1982), authorized a phase out of the ceilings on the maximum rates of interest and dividends that could be paid on deposits. Subsequently, the Garn-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, § 327, 96 Stat. 1469, 1501 (codified in scattered sections of 12 U.S.C. & 15 U.S.C. (1982)), directed the Depository Institutions Deregulation Committee to establish regulations for the new MMDAs. These regulations are set forth at 12 C.F.R. § 1204.122 (1983).

110. See, e.g., Release and Decision of the Comptroller of the Currency, [1982-1983 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 99,284 (Aug. 26, 1982) (approving an application from Security Pacific National Bank to offer discount brokerage services through its new subsidiary, Security Pacific Discount Brokerage Services, Inc.).

Some banks have entered the discount brokerage business by offering in-house brokerage services directly to their customers. See Bisky, *How Are Banks Doing as Discount Brokers?*, A.B.A. BANKING J., Sept. 1983, at 43. Other banks have teamed up with independent brokerage firms. See *OCC Approves Discount Brokerage Acquisition*, BANKING EXPANSION REP., Oct. 4, 1982, at 4.

111. See, e.g., Wallison, *supra* note 106 ("in April 1982 the Comptroller gave preliminary approval to an application by North Carolina National Bank to establish a futures commission merchant subsidiary, which would broker financial futures purchased or sold for hedging by commercial clients"); *Norwest Bank Setting Up Financial Futures Trading Division in Chicago*, Am. Banker, June 13, 1983, at 3 (in June 1983, Norwest Bank of Minneapolis set up a financial futures division based in Chicago).

112. South Dakota Senate Bill No. 256, signed by the Governor of South Dakota on March 4, 1983, and entitled "An act to revise the provisions for ownership, powers, operation and taxation of certain banks and their subsidiaries and to declare an emergency" permitted out-of-state banks and bank holding companies to enter the insurance business in South Dakota. 1983 S.D. Sess. Laws ch. 346, § 39 (codified at S.D. CODIFIED LAWS ANN. § 51-18-30

loan associations and banks are used as retail outlets for sales of insurance contracts underwritten by independent insurers.<sup>113</sup> Insurance companies have offered variable annuities and variable life insurance contracts having securities attributes as well as insurance attributes.<sup>114</sup> Financial products and institutions that cross traditional industry lines have become commonplace.

1. *Cross-Industry Products.—(a) The Central Asset Management Account.—*The central asset management account combines features traditionally found in checking accounts, money market funds, and brokerage accounts.<sup>115</sup> It also presents a clear example of the problems associated with devising an effective regulatory scheme for cross-industry products. As long as jurisdiction is limited by notions of institutional type, it will be difficult to devise an effective regulatory plan for products like the

(Supp. 1983)). Citicorp described its plans to enter the insurance business in an application dated May 13, 1983, to acquire American State Bank of Rapid City, South Dakota. As described in its application to the Federal Reserve Board, Citicorp intended to offer life insurance products, property and casualty insurance, accident and health insurance, and mortgage guaranty insurance, and its insurance activities concerning these products would include underwriting, marketing, and sales. *Citicorp's Insurance Plans*, BANKING EXPANSION REP., July 18, 1983, at 5.

113. Savings and loan service corporations may provide insurance brokerage or agency services for liability, casualty, automobile, life, health, accident, or title insurance, but may not provide private mortgage insurance. 12 C.F.R. § 545.74(c)(5)(ii) (1984).

114. See, e.g., Dorsett, *Universal Life Emerges from "Product Revolution,"* 122 TR. & EST., July 1983, at 22.

115. See, e.g., *Advertisement for Dean Witter's Active Assets Account*, Wall St. J., July 20, 1983, at 49, col. 1; Merrill Lynch, Pierce, Fenner & Smith, Inc., Prospectus for Cash Management Account®, dated Sept. 14, 1983.

As advertised, features of Dean Witter's Active Assets Account included the following:

1. Check writing privileges—no minimum balance, no monthly fee, no per check service charge, no limit on amount of checks or on how many customer can use.
2. Automatic sweep into money market fund.
3. Charge card privileges.
4. Check cashing after hours.
5. Securities in brokerage account insured for up to \$25 million.

Wall St. J., July 20, 1983, at 49, col. 1.

The prospectus for the Cash Management Account® program (CMA®) of Merrill Lynch, Pierce, Fenner & Smith, Inc. states that the CMA® offers integrated financial services by linking together three components. Generally, those components are as follows:

1. Securities Account—A conventional Merrill Lynch securities margin account.
2. Money Account—Three no-load money funds investing in short-term securities (*CMA® Money Fund*, *CMA® Government Securities Fund*, and *CMA® Tax-Exempt Fund*).
3. Visa Account—A Visa check/card account maintained by Bank One of Columbus, N.A., Columbus, Ohio.

Free credit balances held in the Securities Account of persons subscribing to CMA® services are automatically invested in shares of one of three Money Funds or deposited with a depository institution, whichever is designated by the participant as the primary account. Merrill Lynch, Pierce, Fenner & Smith, Inc., *supra*.

central asset management account. For example, the SEC regulates mutual funds and sales of securities and the bank regulatory agencies regulate intermediaries that accept deposits and offer transaction accounts. In the case of the central asset management account, although there is a bank in the picture, that bank holds no funds. It performs operations functions and runs a zero balance checking account. The real "deposit" is in the money market fund or, on a more transitional basis, in the free credit balance held at the brokerage firm.

(b) *Variable Insurance Contracts.*—Traditionally, the activities of the insurance industry have been regulated at the state level. Insurance products such as variable annuity contracts, however, have incorporated features not traditionally associated with insurance. The variable annuity was developed as an alternative to fixed dollar annuities which did not reflect inflationary declines in the purchasing power of the dollar. When the Supreme Court determined that variable annuity contracts were securities,<sup>116</sup> they became subject to regulation by the SEC in addition to regulation by insurance and securities commissioners at the state level. Thereafter, insurance company separate accounts were made to fit the mold of investment company regulation under the Investment Company Act of 1940 (Investment Company Act).<sup>117</sup> Subsequently, however, even when new products, such as variable life insurance, have

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116. In *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959) (the *VALIC* case), the Court held that the variable annuity contract in question was a security outside the exemption provided by § 3(a)(8) of the Securities Act of 1933, 15 U.S.C. § 77c(a)(8) (1982). The provision exempts "any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency . . . of any State . . . or the District of Columbia." *Id.* The Court analyzed both the mortality risk and the investment risk of the variable annuity contract in question:

In some respects the variable annuity has the characteristics of the fixed and conventional annuity: payments are made periodically; they continue until the annuitant's death or in case other options are chosen until the end of a fixed term or until the death of the last of two persons . . . . Each issuer assumes the risk of mortality from the moment the contract is issued . . . . It is this feature . . . that respondents stress when they urge that this is basically an insurance device.

The difficulty is that, absent some guarantee of fixed income, the variable annuity places all the investment risks on the annuitant, none on the company. The holder gets only a *pro rata* share of what the portfolio of equity interests reflects—which may be a lot, a little, or nothing.

359 U.S. at 70-71.

The Court concluded that, in the case of the variable annuity contract before it, "[t]here is no true underwriting of risks, the one earmark of insurance as it has commonly been conceived of in popular understanding and usage." *Id.* at 73.

117. 15 U.S.C. § 80a-3(c)(3) (1982).

Insurance companies are exempt from the Investment Company Act if they are "organized as an insurance company, whose primary and predominant business activity is the

been structured to avoid the same regulatory fate as the variable annuity, the SEC has asserted jurisdiction, creating further questions about the reach of the Investment Company Act.<sup>118</sup>

2. *Cross-Industry Institutions.*—So-called near-banks illustrate the structural and organizational changes that are making traditional distinctions among institutional types untenable. "Near-banks" are financial conglomerates, sometimes called "financial supermarkets," that offer a complete range of financial services to their customers. They often include "nonbank banks,"<sup>119</sup> which carry on many traditional banking functions but avoid many of the prohibitions on securities and interstate activities by escaping the classification of a "bank" under section 1841(c) of the Bank Holding Company Act<sup>120</sup> or under other statutes which define "bank" by reference to the Bank Holding Company Act definition. The result is a single enterprise, one part of which may be supervised by one or more bank regulators, another part by state insurance regulators, another part by the SEC, and yet another part by the CFTC, without comprehensive regulatory oversight.

A number of significant and highly visible national and regional corporations have entered the financial services industry and tested the

writing of insurance . . . and which is subject to supervision by the insurance commissioner . . . of a State . . . ." *Id.* § 80a-2(a)(17). In the *VALIC* case, the Court observed that:

While the term "security" as defined in the Securities Act [15 U.S.C. § 77(b)(1)] is broad enough to include any "annuity" contract, and the term "investment company" as defined in the Investment Company Act [15 U.S.C. § 80a-3] would embrace an "insurance company," the scheme of the exceptions lifts *pro tanto* the requirements of those two Federal Acts to the extent that [entities] are actually regulated by the States as insurance companies, *if indeed they are such.*

359 U.S. at 67-68 (emphasis in original). *See also* G. Hughes, *The Insurance Industry: Products, Distribution Channels and the Challenge of Integrating Financial Services* (outline prepared for Sixty-Fourth American Assembly, Apr. 7-10, 1983, Arden House, Harriman, New York, *The Future of American Financial Services Institutions*).

118. *See, e.g.*, 498 SEC. REG. & L. REP. (BNA) G-1 (Apr. 11, 1979). The text accompanying footnote 20 of the release notes that "whether a company which issues a variety of contracts, some of which qualify as 'insurance' or 'annuities' and, thus, are exempt under section 3(a)(8) of the Act, would be an investment company is a question of fact. A company's status will depend, in the final analysis, upon its total mix of business and the relationship of its securities business to its conventional insurance business." *Id.* n.20.

119. *See supra* note 105.

120. 12 U.S.C. § 1841(c) (1982). Section 1841(c) states that:

"[b]ank" means any institution organized under the laws of the United States, any State of the United States, the District of Columbia, any territory of the United States . . . except an institution the accounts of which are insured by the Federal Savings and Loan Insurance Corporation or an institution chartered by the Federal Home Loan Bank Board, which (1) accepts deposits that the depositor has a legal right to withdraw on demand, and (2) engages in the business of making commercial loans.

*See also Just When Is a Bank Not a Bank? When It Is an Abomination, supra* note 105.

limits of the current regulatory structure. Merrill Lynch offers a complete line of financial services.<sup>121</sup> Sears, Roebuck has expanded beyond its traditional retail sales business into insurance, real estate, investment banking, and stock brokerage.<sup>122</sup> Shearson/American Express is involved in international banking.<sup>123</sup> Prudential is established in both the insurance and securities industries and, in addition, has established a nonbank bank.<sup>124</sup> Many of these firms, even a few years ago, would not have considered each other competitors.

As a result of these developments, interstate banking exists in all but legal form. The definition of the kind of financial institution that is "special" enough to be called a "bank" continues to be elusive, and the multiplicity of financial marketplace regulators has become a nightmare.

3. *Overlapping Regulatory Jurisdictions.*—The inefficiency of the current system of multiple regulators at the state and local levels has been exhaustively catalogued<sup>125</sup> and continues to increase. To a significant extent, this inefficiency is a result of the current system's proclivity for treating similar products differently by regulating along institutional rather than functional lines. For example, deposit-like services with transaction capability offered by money market funds are regulated as investment products under the Investment Company Act, and are therefore subject to rules which differ sharply from those applicable to banks regarding advertising,<sup>126</sup> interstate operations,<sup>127</sup> association with certain types of business affiliates,<sup>128</sup> and reserve requirements.<sup>129</sup> If bank

121. See Gart, *The Financial Conglomerates*, *ECON. REV.*, May 1983, at 21. (published by the Federal Reserve Bank of Atlanta). See generally McMurray, *supra* note 97.

122. A. GART, *THE INSIDER'S GUIDE TO THE FINANCIAL SERVICES REVOLUTION* 42-47 (1984).

123. See Gart, *supra* note 121, at 22.

124. Wallison, *supra* note 106.

125. See, e.g., HOUSE COMM. ON BANKING, CURRENCY AND HOUSING, 94TH CONG., 1ST SESS., *FINANCIAL INSTITUTIONS AND THE NATION'S ECONOMY (FINE): DISCUSSION PRINCIPLES* 11-14 (Comm. Print Nov. 1975).

126. 17 C.F.R. § 230.482 (1983). Both the Securities Act and the Investment Company Act require extensive disclosure of pertinent information in advertisements to prospective investors in money market funds.

127. Unlike member banks of the Federal Reserve System, which are subject to the McFadden Act, money market funds are not prohibited from engaging in interstate operations, subject to disclosure requirements.

128. Investment Company Act of 1940, Pub. L. No. 76-768, § 17, 54 Stat. 789, 815-17 (codified as amended at 15 U.S.C. § 80a-17 (1982)).

129. A difference in treatment exists with respect to the check redemption features of money market funds and banks. While reserve requirements are imposed on transaction accounts offered by "depository institutions," 12 U.S.C. § 461(b) (1982), money market funds are not viewed as depository institutions. Therefore, although the check redemption features

brokerage activities are conducted by a bank holding company subsidiary, they are regulated by the SEC;<sup>130</sup> if they are conducted by the bank itself, they are exempt from SEC regulation and are regulated by the bank regulators.<sup>131</sup> Moreover, investment management activities by banks, even if carried on pursuant to straightforward investment management agreements rather than trust arrangements, are exempt from the Investment Advisers Act,<sup>132</sup> and are regulated by the bank regulators. Identical arrangements by nonbanks are subject to the provisions of the Investment Advisers Act.

An even more dramatic example of inconsistency is the disparate treatment of commingled pension fund assets managed by banks and by independent investment managers.<sup>133</sup> It is generally accepted that the efficient management of pension funds requires that the assets of more than one fund be managed on a commingled basis. If that commingling is done by an independent investment manager rather than by the trust department of a bank, the result is an investment company subject to registration and regulation under the Investment Company Act.<sup>134</sup> Investment companies are subject to the advertising controls set forth in the Securities Act,<sup>135</sup> the Securities Exchange Act,<sup>136</sup> and the rules and regulations promulgated thereunder by the SEC.<sup>137</sup> They are also sub-

of money market fund sponsored transaction accounts operate in a manner similar to transaction accounts offered by depository institutions, the Federal Reserve Board cannot impose reserve requirements on the money market funds under existing law.

130. When banks and bank holding companies employ subsidiaries and affiliates to perform brokerage services, the exemptions from the federal securities laws applicable to banks do not apply. Thus, the provisions of the Securities Act would apply to brokerage activities conducted by a bank holding company subsidiary.

131. Banks remain exempt from the Securities Act. They are subject only to supervision by the appropriate bank regulatory agencies. 15 U.S.C. § 78*l*(i) (1982). In 1974, the bank regulatory agencies were directed to issue securities regulations for banks that were "substantially equivalent" to those issued by the SEC. Pub. L. No. 93-495, 88 Stat. 1500, 1503-04 (codified at 15 U.S.C. § 78*l*(i) (1982)).

132. Banks and bank holding companies are exempt from the definition of the term "investment adviser" set forth in the Investment Advisers Act, 15 U.S.C. § 80b-2(a)(11) (1982). Bank affiliates or subsidiaries, however, are not so exempt and are subject to the Investment Advisers Act when they perform investment advisory services within the coverage of the Act.

133. While individual investment managers are subject to the provisions of the Investment Company Act of 1940, 15 U.S.C. § 80a-3(a)(1982), banks are expressly excluded from the Act's coverage, *id.* § 80a-3(c)(3).

134. *Id.* § 80a-3(a).

135. *Id.* § 77g.

136. *Id.* § 78j(b).

137. Rule 10b-5, promulgated under the Securities Exchange Act of 1934, makes it "unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails" to make representations which are materially misleading "in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5 (1983).

Rule 134, promulgated under the Securities Act of 1933, permits specified items of

ject to the terms of the Investment Company Act and the Investment Advisers Act.

In contrast, bank common and collective trust funds are subject to quite different regulatory treatment. The concept of a common trust fund was first recognized in the Revenue Act of 1936,<sup>138</sup> which established a tax exemption for bank common trust funds "maintained by a bank . . . (1) exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, . . . or guardian; and (2) in conformity with the rules and regulations . . . of the Board of Governors of the Federal Reserve System."<sup>139</sup> Congress made it clear that the bank regulators were to assure that bank common trust funds would not be "over-commercialized" or used for "speculative purposes."<sup>140</sup> In 1937, the Federal Reserve Board adopted section 17 of Regulation F, authorizing national and state member banks to establish common trust funds.<sup>141</sup> Section 17 expressly provided that the new authority could not be used to promote commingled investment management services.<sup>142</sup> The Federal Reserve Board accompanied its strict limitations on the use of common trust funds with equally strict prohibitions against bank advertising of such funds.<sup>143</sup> Similar restrictions on the promotion of common trust funds have been maintained by the Comptroller of the Currency through regulations which flatly forbid advertising and only permit distributing copies of the financial reports of common trust funds to persons who request them or to prospective trust customers.<sup>144</sup>

Additional examples of such overlapping and inconsistent jurisdic-

information to be included in investment company advertising without requiring that the advertising be preceded or accompanied by a prospectus. *Id.* § 230.134.

Rule 156, promulgated under the Securities Act of 1933, is interpretative in nature and highlights the types of representations which the SEC's experience suggests are most likely to be misleading. *Id.* § 230.156.

Rule 482, recently issued by the SEC under the Securities Act of 1933, further increases the flexibility and scope of investment company advertising by permitting investment companies to publish a broader range of information than was previously permitted, through the use of an "omitting prospectus." *Id.* § 230.482.

138. Ch. 690, § 169, 49 Stat. 1648, 1708 (codified at I.R.C. § 584 (1982)).

139. 49 Stat. at 1708.

140. Amendments to Regulation F, 2 Fed. Reg. 3440 (1937).

141. *Id.*

142. Section 17 states, in part, that "the operation of such common trust funds as investment trusts for other than strictly fiduciary purposes is hereby prohibited." *Id.*

143. *Id.*

144. The regulations of the Comptroller of the Currency do not permit a bank to advertise its common trust fund service. A bank may indicate, however, that it has an annual report available concerning its common trust fund activities in connection with the promotion of its fiduciary services. 12 C.F.R. § 9.18(b)(5)(iv)-(v) (1983).



tions are seen in the regulation of mutual funds, commodity futures pools, stock options, and commodity futures options. Like mutual funds, commodity futures pools are subject to the advertising and disclosure requirements of the Securities Act. Unlike mutual funds, however, commodity futures pools are not subject to substantive regulation under the Investment Company Act and the Investment Advisers Act. Options on stocks are policed by the SEC, while options on commodity futures are regulated by the CFTC.<sup>145</sup> Stock option investors get Securities Investor Protection Corporation (SIPC) protection, while commodity options purchasers have no insurance if a broker fails.<sup>146</sup> Margin rules for financing options transactions are set by the Federal Reserve Board, while margin rules for financing commodities transactions are set by the boards of the futures exchanges.<sup>147</sup>

4. *Demise of Glass-Steagall.*—The crumbling of Glass-Steagall Act barriers to investment activities by commercial banks has been well documented.<sup>148</sup> Suffice it to say that the Congress, courts, and regulators have permitted all of the following securities activities by banks or bank holding company subsidiaries (some of which are currently the subject of litigation):

- underwriting and dealing in Treasury bonds and state and local general obligation bonds;<sup>149</sup>
- underwriting and dealing in many types of state and local revenue bonds;<sup>150</sup>

145. CFTC regulations relating to commodity option transactions are set forth at 17 C.F.R. § 32 (1983).

146. Stock option investors are protected by the Securities Investor Protection Act of 1970, 15 U.S.C. § 78aaa (1982). Regulations for the protection of commodity options purchasers are set forth at 12 C.F.R. § 166 (1983).

147. Compare Regulation U, 12 C.F.R. §§ 221.1-4 (1983) (providing an example of margin regulation by the Federal Reserve Board), with 17 C.F.R. § 1.30 (1983) (providing an example of margin regulation by the CFTC).

148. See, e.g., Pitt & Williams, *supra* note 89; Note, *A Conduct-Oriented Approach to the Glass-Steagall Act*, 91 YALE L.J. 102 (1981).

149. See, e.g., 12 C.F.R. § 1.3(g) (1983). The Glass-Steagall Act permits banks to underwrite general obligation bonds of state and local governments. Such bonds are backed by the full faith and credit of a governmental body having general powers of taxation, including property taxation.

150. Banks are prohibited by the Glass-Steagall Act from underwriting bonds issued by a state or municipality unless those bonds represent general obligations. 12 U.S.C. § 24 (1982). Revenue bonds, unlike "general obligations" are not backed by the full resources and taxing power of a governmental unit, but only by the resources of a particular revenue producing project or separate source of funds. In the early 1960's, the Comptroller of the Currency issued several rulings permitting national bank underwriting of state and municipal bonds which were not backed by entities having general taxing powers. Investment Securities Regulation, Eligibility of Specific Bond Issues for Purchase by National Banks, 27 Fed. Reg. 6748-

- acting as financial adviser to issuers of state and local revenue bonds;<sup>151</sup>
- acting as a discount broker, and perhaps a full service broker, for corporate securities of all kinds;<sup>152</sup>
- underwriting and dealing in corporate securities of all kinds outside the United States;<sup>153</sup>
- acting as agent for corporations in arranging private placements of debt and equity securities;<sup>154</sup>
- acting as broker for interest-rate futures contracts;<sup>155</sup>

49 (1962). The Federal Reserve Board, on the other hand, disagreed with the comptroller's interpretation and specifically prohibited state member banks from underwriting these types of bonds. 12 C.F.R. § 250.120 (1983). In *Baker, Watts & Co. v. Saxon*, 261 F. Supp. 247, 252 (D.D.C. 1966), *aff'd sub nom. Port of N.Y. Auth. v. Baker, Watts & Co.*, 392 F.2d 497 (D.C. Cir. 1968), the court followed the position taken by the Federal Reserve Board and held that banks may only underwrite bonds which are backed by the full faith and credit of a governmental entity possessing general powers of taxation. However, as determined by both the Comptroller of the Currency and the Federal Reserve Board, the bonds do not have to be issued by such an entity, but only directly or indirectly backed by one. 12 C.F.R. §§ 1.120, 250.122 (1983); *see also* Eligibility of Securities for Purchase, Dealing in, Underwriting and Holding by National Banks, 47 Fed. Reg. 5701, 5702-03 (1982) (comments). Moreover, 12 U.S.C. § 24 periodically has been amended to permit banks to underwrite and deal in certain kinds of revenue bonds.

151. *See, for example*, the decision of the Supreme Court in *Board of Governors v. Investment Co. Inst.*, 450 U.S. 46, 55 (1981). The Court characterized investment advisory activities as a facet of the traditional fiduciary functions of banks. Banks and bank holding companies are exempt from the definition of the term "investment adviser" under the Investment Advisers Act, 15 U.S.C. 80b-2(11) (1982).

152. Discount brokerage activities performed by banks or bank holding companies have been determined not to violate the Glass-Steagall Act. *See Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.*, 716 F.2d 92, 100 (2d Cir. 1983), *aff'd*, 104 S. Ct. 1905 (1984); *Securities Indus. Ass'n v. Comptroller of the Currency*, [Current] FED. BANKING L. REP. (CCH) ¶ 99,771 (D.D.C. Nov. 2, 1983). The Comptroller of the Currency recently authorized a combination of discount brokerage and traditional bank investment management services. Application of American National Bank of Austin, Texas, [Current] FED. BANKING L. REP. (CCH) ¶ 99,732 (Sept. 23, 1983).

153. *See generally* Securities Act of 1933, Pub. L. No. 73-22, §§ 2(7), 5, 48 Stat. 74, 75, 77-78 (codified as amended at 15 U.S.C. § 77b(7), e (1982)) (section 2(7) of the Act defines interstate commerce as including trade or commerce in securities between a state and any foreign country; section 5 sets forth requirements to be met before securities can be traded or sold in interstate commerce).

154. *See generally* The New York Clearinghouse Association, *Commercial Bank Private Placement Advisory Services: The Legal and Public Policy Issues*, 95 BANKING L.J. 333 (1978).

The Comptroller of the Currency has indicated that, in his opinion, "the proper legal judgment is that Glass-Steagall does not prohibit private placement activity as presently conducted by commercial banks." *Propriety of National Bank Private Placement Activity in Light of the Glass-Steagall Act*, [1978-1979 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 85,107, at 77,103 (Dec. 9, 1978).

155. A recently promulgated federal regulation includes the following in a list of permissible nonbanking activities for bank holding companies and their subsidiaries:

Acting as a futures commission merchant for nonaffiliated persons in the execution and clearance on major commodity exchanges of futures contracts and options on futures contracts for bullion, foreign exchange, government securities, certificates of

- acting as investment manager for individuals, trusts, pension funds, and investment companies of all kinds.<sup>156</sup>

Whatever legal analysis tells us about the correctness of the foregoing judgments, it is plain that the Glass-Steagall Act has lost its moral force.

5. *De Facto Interstate Banking.*—(a) *Banking Services.*—As one observer recently noted, “Although interstate banking is prohibited by the McFadden Act and the Douglas Amendment, the fact is that banking organizations are providing services across state lines and have been doing so for some time.”<sup>157</sup> In non-retail banking, especially when conducted by the largest corporations in the United States, the “bars” to interstate banking have little importance.<sup>158</sup> One recent study found that domestic banking organizations control at least 7383 interstate offices, and if interstate offices of foreign banking organizations are included, the total reaches 7840.<sup>159</sup> Almost 1500 such interstate offices supply general banking services. The Bank Holding Company Act allows bank holding companies to establish or acquire nonbank subsidiaries which provide lending and related services “closely related to banking” that are not subject to the prohibitions on interstate banking.<sup>160</sup> Moreover, loan production offices<sup>161</sup> and nonbank subsidiaries

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deposit and other money market instruments that a bank may buy or sell in the cash market for its own account if [certain conditions are met].

49 Fed. Reg. 826, 828 (1984) (to be codified at 12 C.F.R. § 225.25).

156. For example, pursuant to Regulation Y, 12 C.F.R. § 225 (1983), and related interpretative rulings, the Federal Reserve Board has determined that a bank holding company may act as an investment adviser for an open-end or closed-end investment company, and in addition, may organize, operate, or control a closed-end investment company. See 12 C.F.R. §§ 225.4(a)(5), 225.125 (1983). In *Board of Governors v. Investment Co. Inst.*, 450 U.S. 46, 78 (1981), the Supreme Court specifically upheld the Federal Reserve Board's regulation with respect to advising closed-end companies.

157. Whitehead, *Interstate Banking: Taking Inventory*, ECON. REV., May 1983, at 4 (published by the Federal Reserve Bank of Atlanta).

158. See Brouillette, *supra* note 97, at 1; Fraust, *Crossing State Lines*, *supra* note 97, at 1; Fraust, *Banks Stake Out An Interstate Future*, *supra* note 97, at 1.

159. Whitehead, *supra* note 157, at 18. Whitehead found a total of 55,440 banking offices in the United States.

160. 12 U.S.C. § 1843(c)(8) (1982). The Bank Holding Company Act allows bank holding companies to offer virtually any “bank-like” service, except the acceptance of deposits, on a multi-state basis. Thus, bank holding companies have activated nationwide networks of consumer finance, mortgage banking, and other financial activities.

161. An interpretative ruling of the Comptroller of the Currency authorizes national banks to operate “loan production offices” for the purpose of originating loans. The ruling states that such offices will not be considered “branches” within the meaning of 12 U.S.C. § 36(f), provided that the loans are approved and made at a main or branch office of the bank. 45 Fed. Reg. 53,080 (1980) (codified at 12 C.F.R. § 7.7380 (1984)).

For a time, the future of loan production offices was in doubt. In 1979, the District Court for the District of Columbia, holding that loan production offices constituted branch banks under 12 U.S.C. § 36, ordered the Comptroller of the Currency to rescind its interpre-

such as Edge Act corporations<sup>162</sup> allow banks to provide interstate financial services.

Even in the area of retail banking, deposit taking and consumer lending functions present clear examples of the reality of interstate banking. Banks accept deposits indirectly from all over the country.<sup>163</sup> Money market funds operate without concern for state boundaries when they perform a commingling function for small account holders and purchase large certificates of deposit (CDs) issued by banks.<sup>164</sup> Moreover, securities firms have begun to market, through their nationwide offices, the insured CDs of banks and savings institutions.<sup>165</sup> The consumer lending function presents even clearer evidence of de facto interstate banking. The advent of credit card lending by bank owned finance and mortgage companies represents a substantial penetration of the consumer loan market throughout the country.

(b) *Activities of States Promoting Interstate Banking.*—States have acted directly to position themselves for, and promote the legalization of, interstate banking. Delaware, for example, passed its Financial Center Development Act (FCDA)<sup>166</sup> in February 1981. The FCDA was Delaware's invitation to out-of-state banks to establish banking operations within the state. It was premised on the Douglas Amendment's prohibition on interstate banking except in the case of express invitation by state legislation. Its provisions included elimination of interest rate ceilings for banks, flexible credit provisions, and low rates of bank taxation.<sup>167</sup>

On December 30, 1982, Massachusetts enacted a law<sup>168</sup> "permit-

tative ruling. The following year, however, the district court's decision was reversed on appeal and the comptroller's interpretative ruling was reinstated. *Independent Bankers Ass'n of Am. v. Heimann*, 627 F.2d 486 (D.C. Cir. 1980). The court of appeals reversed, not on the merits, but because the IBAA had delayed bringing suit until 12 years after the interpretative ruling was published and was therefore barred by laches. The court noted, however, that "we have serious questions about" the district court's decision on the merits as well. *Id.* at 488.

162. So-called Edge Act corporations operate on a multi-state basis and offer both deposit and loan services as long as they are confined to international trade and are available only for that service to business customers. *See* 12 U.S.C. §§ 611-632 (1982). The International Banking Act of 1978, 12 U.S.C. §§ 3101-3108 (1982), substantially broadened the powers of Edge Act corporations by authorizing the Federal Reserve Board to allow them to branch interstate and to broaden their operating flexibility.

163. *See supra* note 158.

164. *Id.*

165. *Id.*

166. DEL. CODE ANN. tit. 5, § 770 (Supp. 1982).

167. Ripsom, Swayze & Sheehan, *A Review of Delaware Banking Developments*, BANKING EXPANSION REP., Nov. 7, 1983, at 1, 13.

168. 1982 Mass. Adv. Legis. Serv. 626 (Law. Co-op.) (codified in scattered sections of MASS. GEN. LAWS ANN. chs. 167, 167A, 167B, 167C, 167E, 168, 170, 172 (West 1984)).

ting depository institutions, or their holding companies, in any of the five other New England states to merge with or acquire banks or thrift institutions in Massachusetts, so long as the entering institution is in a New England state that has enacted a reciprocal law permitting entry by Massachusetts' financial institutions."<sup>169</sup> Connecticut and Rhode Island have also enacted regional reciprocity statutes,<sup>170</sup> which permit bank holding companies in other New England states to acquire or create new in-state banks, provided that the home state of the out-of-state bank holding company has a similar statute.<sup>171</sup> Although it has approved transactions based on reciprocity statutes, the Federal Reserve Board has expressed concern about the development of regional interstate banking, observing that "there is a potential danger that the result could be to divide the country into a number of banking regions."<sup>172</sup>

(c) *Interstate Expansion of Savings and Loan Associations.*—Although there is no statutory prohibition on interstate activities by savings and loan associations, until recently the FHLBB prohibited such activities. The need to find merger partners for failing thrift institutions, however, has encouraged more flexibility on the part of the FHLBB. On August 16, 1982, the FHLBB announced that Fidelity Savings and Loan Association of Oakland, California (Fidelity), would be acquired by Citicorp.<sup>173</sup>

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169. Golembe, *Massachusetts and Interstate Banking*, BANKING EXPANSION REP., Jan. 17, 1983, at 1.

Citicorp has challenged the Massachusetts statute and a similar Connecticut statute on the grounds that they violate the contract, commerce, and supremacy clauses of the United States Constitution. Memorandum of Citicorp in Opposition to the Application for Approval to Merge, *In re* Application of Bank of New England Corp., Proceedings before the Board of Governors of the Federal Reserve System, Dec. 1983.

170. The Connecticut and Rhode Island statutes are located, respectively, at 1983 Conn. Legis. Serv. 411 (West); R.I. GEN. LAWS § 19-30-2 (Supp. 1983).

171. Maine allows out-of-state bank holding companies to acquire in-state banks on essentially the same terms that apply to acquisitions by in-state holding companies. ME. REV. STAT. ANN. tit. 10, § 1013 (Supp. 1983). Three New England transactions based on regional reciprocity statutes have been approved by the Federal Reserve Board: (1) Bank of New England Corporation received approval to acquire CBT Corporation, 70 FED. RESERVE BULL. 374 (1984); (2) Hartford National Corporation received approval to acquire Arltru Bancorporation, 70 FED. RESERVE BULL. 353 (1984); and (3) Bank of Boston Corporation received approval to acquire Colonial Bancorp of Connecticut, Federal Reserve Board decision of May 18, 1984, *discussed in* BANKING EXPANSION REP., June 4, 1984, at 2-3.

172. Federal Reserve Board decision, *cited in* BANKING EXPANSION REP., *supra* note 171; *see also* 70 FED. RESERVE BULL. 374 (1984).

173. Order, Federal Home Loan Bank Board, Aug. 16, 1982. The FHLBB had sought a merger partner for Fidelity since April 1982, when Fidelity was put into FSLIC receivership and bids were invited. Under the terms of the Citicorp bid that was approved, FSLIC assistance could amount to \$165 million over the twelve-year term of the proposal, but would decline to \$50 million if short-term interest rates were to fall to less than 10%. Citicorp agreed to provide enough equity capital to increase Fidelity's net worth to 3% of its liabilities and to

The approval of the Federal Reserve Board also was required because the acquisition fell under section 1843(c)(8) of the Bank Holding Company Act.<sup>174</sup> The Federal Reserve Board issued its approval on September 28, 1982.<sup>175</sup> In allowing Citicorp to acquire Fidelity, the first instance of a cross-industry interstate merger, the Federal Reserve Board said it took into account "the beneficial effect on the financial community as a whole of implementing an additional mechanism for the solution of difficult problems for the thrift industry and the federal insurance funds posed by the poor earnings" of the thrift industry.<sup>176</sup>

Subsequently, the FHLBB proposed a rule to permit nonsupervisory interstate mergers, acquisitions, and branching when state laws specifically permit entry by out-of-state institutions.<sup>177</sup> The FHLBB advocated a "host state" approach under which a federally-chartered thrift could branch into a state, either by establishing a new office there or by merging with an institution in the host state, provided that the host state permitted state-chartered thrifts from other states to engage in similar activities.

*(d) Interstate Expansion of Nonbank Banks.*—The possibility of acquiring nonbank banks in a number of states to form an interstate organization without regard to the strictures of the Douglas Amendment<sup>178</sup> is the aspect of nonbank bank expansion which is most threatening to traditional regulatory patterns. Such networks of nonbank banks have the potential to link brokerage, commercial, and industrial activities with interstate deposit taking.<sup>179</sup>

Dimension Financial Corporation (Dimension) provides a good

provide additional equity as needed to maintain that ratio. The FHLBB estimated Citicorp's initial contribution at more than \$80 million.

174. See 12 U.S.C. § 1843(c)(8) (1982).

175. Citicorp, 68 FED. RESERVE BULL. 656 (1982).

176. This was, of course, a departure from established policy. In 1977, for example, in its Order Denying Retention of Empire Savings, Building and Loan Association by D.H. Baldwin Company (*cited in id.* app.), the Federal Reserve Board identified three potential adverse effects that could be expected to result from the affiliation of a bank and a savings and loan association:

- (a) a conflict between the statutory and regulatory frameworks within which such banks and savings and loan associations operate;
- (b) an erosion of institutional rivalry between banks and savings and loan associations; and
- (c) a potential for undermining federal prohibitions against interstate banking.

63 FED. RESERVE BULL. 280 (1977).

177. Interstate Transactions Involving Insured Institutions, 48 Fed. Reg. 20,930 (1983) (to be codified at 12 C.F.R. §§ 556.5, 563.22)(proposed May 10, 1983).

178. 12 U.S.C. § 1842(d) (1982).

179. See Eisenbeis, *Regional Forces for Interstate Banking*, ECON. REV., May 1983, at 24 (published by the Federal Reserve Bank of Atlanta).

example of the interstate expansion possibilities of nonbank banks. In 1983, Dimension announced plans to set up thirty-one consumer oriented nonbank banks in twenty-five states.<sup>180</sup> Since these banks would not engage in commercial lending, and would therefore not constitute "banks" within the meaning of the Bank Holding Company Act,<sup>181</sup> Dimension would not be subject to the interstate restrictions of the Douglas Amendment or the regulatory supervision of the Federal Reserve Board. On May 9, 1984, the comptroller granted preliminary approval to Dimension to organize four banks and gave Dimension thirty days to designate which four banks it would organize.<sup>182</sup> The comptroller stated that Dimension's "applications represent a sound banking concept . . . [which is] permissible under applicable federal statutes."<sup>183</sup> Because Dimension had no operating history, however, the comptroller reserved judgment on the remaining twenty-seven applications. Dimension will be permitted to renew its request for preliminary approvals of additional banks only after the initial four banks have opened and have established satisfactory operating records.<sup>184</sup>

### III. PREVIOUS ATTEMPTS AT REGULATORY REFORM

Economic forces have thrust market participants into fierce competition. The rate of development of new financial products has been extraordinary, and as each new product forces itself through a real or imagined loophole in the complex set of laws that govern financial institutions, regulators and the Congress are faced with the decision of whether to permit the development or to intervene and stop it. The enormous inertia retarding legislative change usually prompts a decision, by design or default, to do nothing.

#### A. *Studies and Commissions*

Part of the reason for this inertia is the uncomfortable feeling among politicians and regulators that individual steps to restructure the markets or the regulatory system should only be taken as part of an overall plan. That notion was surely behind Congressman Timothy Wirth's call for a Capital Markets Commission,<sup>185</sup> SEC Chairman John

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180. *Am. Banker*, Feb. 18, 1983, at 1; *Wall St. J.*, Feb. 18, 1983, at 6, col. 3.

181. *See supra* note 105.

182. Decision of the Comptroller of the Currency on the Applications of Dimension Financial Corporation to Charter Thirty-One National Banks in Twenty-Five States (May 9, 1984), reprinted in 42 *WASH. FIN. REP. (BNA)* 815 (May 14, 1984).

183. *Id.*

184. *Id.*

185. In August 1982, Representative Timothy Wirth introduced legislation to establish a Capital Markets Commission to study and evaluate the nation's long-term capital require-

Shad's proposal to simplify and rationalize regulation of financial services,<sup>186</sup> and the Reagan administration's more limited step in appointing the Bush Task Group.<sup>187</sup>

The preference for studying the big picture is not surprising, nor is it new.<sup>188</sup> Previous efforts to review the regulation of financial institutions have been more or less systematic attempts to look at what was

ments and to determine what changes might be needed in federal and state financial policies to meet these requirements. The Capital Markets Commission was to have been charged with four primary functions:

1. Examination of the capital needs of the United States economy to sustain short-term and long-term economic growth, by business sector and geographic region;
2. Examination of the ability of financial intermediaries to raise and allocate such capital;
3. Analysis of the impact of federal and state laws and policies on such matters as the fairness and efficiency of capital allocation, the fairness of competition between such intermediaries, and the impact of differences in regulation over intermediaries offering similar instruments and products; and
4. Assessment of the safety and soundness of financial intermediaries.

H.R. 7014, 97th Cong., 2d Sess. (1982).

186. On February 4, 1982, Chairman John Shad of the SEC proposed a program to simplify and rationalize regulation of financial services. The SEC program would begin with the appointment of a nonpartisan task force of experienced executives and authorities who would study the possibility of regulating certain products and activities by functions rather than by "outmoded industry classifications." The task force would consider consolidation of related regulatory activities with a view toward reducing conflicts and administrative costs and increasing operational efficiency and financial flexibility. *SEC Proposes Five-Point Program to Reform Financial Services Regulation*, 14 SEC. REG. & L. REP. (BNA) 251 (Feb. 10, 1982).

187. In its request for public comments on the problems and possible reorganization of the existing system of federal regulation of financial institutions and services, the Bush Task Group cited a number of reform issues and options, including: (a) the reorganization of depository regulators; (b) the possible reorganization, consolidation, or coordination of issues among agencies dealing with securities trading, commodity futures trading, and depository institutions; (c) the possible consolidation of the three federal deposit insurance agencies and the Securities Investor Protection Corporation (SIPC); and (d) the extent to which current regulatory or statutory restrictions on financial institutions or their holding companies should be eliminated or modified. 48 Fed. Reg. 5704 (1983).

188. The sheer number of studies which have considered banking regulation is impressive. Prominent studies include: *Financial Institutions Supervisory Act of 1966: Hearings on S. 3158 Before the Subcomm. on Financial Institutions of the Senate Comm. on Banking and Currency*, 89th Cong., 2d Sess. (1966); *Consolidation of Bank Examining and Supervisory Functions: Hearings on H.R. 107 and H.R. 6885 Before the Subcomm. on Bank Supervision and Insurance of the House Comm. on Banking and Currency*, 89th Cong., 1st Sess. (1965); *Conflict of Federal and State Banking Laws: Hearings Before the House Comm. on Banking and Currency*, 88th Cong., 1st Sess. (1963); *Proposed Federal Banking Commission and Federal Deposit and Savings Insurance Board: Hearings on H.R. 729 and H.R. 5874 Before the Subcomm. on Banking Supervision and Insurance of the House Comm. on Banking and Currency*, 88th Cong., 1st Sess. (1963); *Increased Flexibility for Financial Institutions: Hearings on H.R. 5845, H.R. 7878, H.R. 8230, H.R. 8245, H.R. 8247, H.R. 8459, and H.R. 8541 Before the House Comm. on Banking and Currency*, 88th Cong., 1st Sess. (1963); *Review of the Report of the Commission on Money and Credit: Hearings Before the Joint Economic Comm.*, 87th Cong., 1st Sess. (1961); COMM. ON FINANCIAL INSTITUTIONS, REPORT TO THE PRESIDENT OF THE UNITED STATES (1963).



perceived as the "whole" of the regulatory structure. In 1962, for example, the Advisory Committee on Banking to the Comptroller of the Currency (Comptroller's Committee) recommended that the Federal Reserve Board's bank supervisory powers be terminated and that supervisory authority relating to national banks be transferred entirely to the Comptroller of the Currency.<sup>189</sup> All authority relating to state banks would have been transferred to the FDIC, and the FDIC was to be reorganized and placed under the control of a single administrator within the Treasury Department. The Comptroller's Committee also suggested that authority over the formation and expansion of bank holding companies be transferred from the Federal Reserve Board to the Comptroller of the Currency, and that the Federal Reserve Board's authority to set margin requirements and deposit interest rates be transferred to the Secretary of the Treasury. Furthermore, the authority of the Federal Reserve Board and the FDIC to regulate branches of state banks was to be relinquished to the respective state bank supervisory agencies.<sup>190</sup>

In 1971, the Hunt Commission, bowing to the political power of state bank regulators, recommended establishing three new agencies: the Office of the National Bank Administrator, which would have the supervisory responsibilities of the Comptroller of the Currency with respect to national banks and would be an agency independent of the Treasury Department; the Office of the Administrator of State Banks, which would assume the examination and supervision responsibilities for state-chartered insured commercial and mutual savings banks currently exercised by the Federal Reserve Board and the FDIC; and the Federal Deposit Guarantee Administration, which would incorporate under its umbrella the FDIC, the FSLIC, and the Credit Union Insurance Corporation (CUIC).<sup>191</sup> The Federal Reserve Board would have retained its authority to implement monetary policy and administer the Bank Holding Company Act.<sup>192</sup>

In 1975, a study commissioned by the House Committee on Banking, Currency, and Housing (commonly referred to as the "FINE Study") recommended creating a single supervisory agency, the Federal Depository Institutions Commission, which was to administer all supervisory functions of the FDIC, the Federal Reserve Board, the Comptrol-

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189. ADVISORY COMM. ON BANKING, COMPTROLLER OF THE CURRENCY, NATIONAL BANKS AND THE FUTURE 138 (1962).

190. *Id.*

191. U.S. PRESIDENT'S COMM'N ON FINANCIAL STRUCTURE AND REGULATION, REPORT 87-92 (1971).

192. *Id.*

ler of the Currency, the FHLBB, and the NCUA.<sup>193</sup> A subsidiary agency of the Federal Depository Institutions Commission would have handled insurance functions.<sup>194</sup>

### *B. The Problem With Shifting Boxes On Organizational Charts*

The problem with all of the foregoing efforts at regulatory restructuring is that they attempt to find a new congruence between financial institutions and existing regulators. That task requires a prescience about the ultimate shape of the financial industry that is simply beyond the powers of government planners and advisers, even the blue-ribbon variety. Instead, there must be a fundamental rethinking of regulatory patterns designed to match the financial functions which are to be regulated. In an era dominated by cross-industry financial institutions and products, there is no justification for the regulation of similar functions by different regulators, each operating with distinct substantive and procedural regulations, rules, and standards.

It is time to confront the regulatory anomalies, develop a new taxonomy of the functions performed in the financial marketplace, and devise a new structure for regulating those functions.<sup>195</sup> The creation of a new model—a new paradigm—should be the goal. In creating this new paradigm it may be necessary to discard much of the accumulated regulatory baggage that often has obstructed the vision of those who have previously confronted the problem. As Stephen Toulmin said, "There is only one way of seeing one's own spectacles clearly: that is, to take them off. It is impossible to focus both on them and through them at the same time."<sup>196</sup> It is time to place the data in a new system of relations and provide a new framework for analysis.<sup>197</sup>

## IV. REGULATORY OBJECTIVES

### *A. A Need to Ask Fundamental Questions*

The essential task in the creation of a new paradigm for regulating financial functions and institutions is to identify the regulatory values or goals that have contemporary significance and to design a system that facilitates achievement of these goals. The task must begin with a determination of objectives, proceed to an examination of the alternative

193. *See supra* note 125, at 12.

194. *Id.*

195. *Cf.* T. KUHN, *THE STRUCTURE OF SCIENTIFIC REVOLUTIONS* 52-53 (2d ed. 1970) ("Discovery commences with the awareness of anomaly . . .").

196. S. TOULMIN, *FORESIGHT AND UNDERSTANDING* 101 (1961).

197. *Cf.* H. BUTTERFIELD, *THE ORIGINS OF MODERN SCIENCE 1300-1800*, at 1-7 (rev. ed. 1957).

methods of attaining those objectives, and culminate with the choice of an operating plan.<sup>198</sup> Although that is not an easy undertaking, the very attempt should advance the cause of facilitating more effective and efficient regulation of financial institutions.

### B. Goals of Regulation

The goals that must be achieved by a regulatory system for the financial services industry can be summarized as follows: efficiency of regulation, flexibility, fair dealing, safety and soundness, avoidance of concentration, and efficient implementation of monetary policy.<sup>199</sup>

1. *Efficiency.*—Arthur Okun states in *Equality and Efficiency*,<sup>200</sup> that “The government must be accountable to the citizens, [but] accountability is as costly in resources as it is precious to the integrity of the political process.”<sup>201</sup> Efficiency of regulation is achieved when financial regulators and regulations distort the behavior of market participants only to the extent required to achieve valid public policy goals. Inconsistent, duplicative rules affecting identical financial functions and imposed by different government agencies cause private sector marketing efforts, and therefore capital flows, to be affected by differences in regulatory philosophy rather than by considerations of economic efficiency and equality. Quintessential examples of such inefficiency are the open warfare between the Comptroller of the Currency and the Federal Reserve Board on the “nonbank bank” issue<sup>202</sup> and the differences in regulation of stock index options and stock index futures, which fall under the respective jurisdictions of the SEC and the CFTC.

When a system is based upon inconsistent rules, the mix between regulation and free market activity is sub-optimal. To the extent that the problem is due to overlapping regulatory jurisdiction, as is often the case in the financial marketplace, greater efficiency would be achieved through consolidation of functionally similar regulatory responsibilities.

In making the following suggestions, we do not ignore the formidable political barriers to their implementation. We are not so naive as to suggest that legislative programs embodying these proposals in their en-

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198. Breyer, *Analyzing Regulatory Failure: Mismatches, Less Restrictive Alternatives, and Reform*, 92 HARV. L. REV. 547, 550 (1979).

199. For a summary of traditional goals of financial regulation, see Chase, *The Structure of Federal Regulation of Depository Institutions*, in HOUSE COMM. ON BANKING, CURRENCY AND HOUSING, FINANCIAL INSTITUTIONS AND THE NATION'S ECONOMY: COMPENDIUM OF PAPERS PREPARED FOR THE FINE STUDY 149 (Comm. Print 1976).

200. A. OKUN, *EQUALITY AND EFFICIENCY: THE BIG TRADE-OFF* (1975).

201. *Id.* at 60.

202. *See supra* note 105.

tirety would have any substantial likelihood of immediate success. But individual decisions that, in the aggregate, shape the financial system are being made all the time as part of the ongoing process of political compromise, and we view these proposals as lodestars to guide such decisions and to fix the direction in which the systems should evolve.

The starting point for consolidation efforts should be the transfer of primary responsibility for regulating larger state and national banks and bank holding companies to a single regulator. These institutions compete in the same markets and should be subject not only to the same rules but also to the same set of regulatory attitudes. There are many persons and institutions, of course, who defend the current panoply of multiple regulators on the grounds that it avoids the consequences of monolithic power, provides a competitive counterweight to the heavy hand of regulation, and allows greater opportunity for experimentation.<sup>203</sup> Such arguments have some appeal. There are surely times, of which the present is one, when one regulator prefers to push forward faster than others and thus leads in developing new approaches to systemic problems.

But competition among regulators may work to retard change as well as to implement it. To some extent, the very process of competition among the regulators makes the regulatory system nonadaptive and unpredictable and thereby also inhibits efficiency. Many changes cannot, as a practical matter, be made without the concurrence of all regulators. In those cases, any one agency effectively can veto change. Moreover, even when all regulators are in concurrence, change may be imposed in an uncoordinated manner without regard for the interests of competing financial institutions. For example, in the 1970's the regulators were agonizingly slow to identify the need to phase out deposit interest rate controls, but in the 1980's, those controls were dropped abruptly.

In comparison, the advantages that might be derived from a centralized regulatory authority are considerable.<sup>204</sup> A single regulator would eliminate conflicting goals, achieve greater efficiency and economy of regulation, and eliminate actual or potential policy conflicts between agencies.<sup>205</sup> Such an approach would simplify administration and improve communication both within the regulator itself and be-

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203. See, e.g., Letter from Herbert W. Gray, Chairman of the National Association of Mutual Savings Banks, to Bush Task Group (Mar. 14, 1983).

204. For a listing of unification proposals, see Hackley, *Our Baffling Banking System—Part II*, 52 VA. L. REV. 771, 799-830 (1966). See also Chase, *supra* note 199, at 149-64; Robertson, *Federal Regulation of Banking: A Plea for Unification*, 31 LAW & CONTEMP. PROBS. 673, 686-95 (1966).

205. Robertson, *supra* note 204, at 687.

tween financial institutions and the regulator. A single regulator would also reduce uneven application of identical federal statutes to different financial institutions, and would facilitate prompt adjustment of regulation to changes in the financial markets.

The next step should be to consolidate regulation of different kinds of depository institutions. Surely the safety and soundness, monetary policy, and competitive equality considerations applicable to large savings institutions do not differ materially from those applicable to many large banks. Although there are differences in asset and liability powers between banks and savings and loan associations, and the mortgage-credit allocation functions of savings and loan associations are not applicable to banks, those differences do not reduce the desirability of uniform regulation.

As a complementary step toward rationality, the jurisdiction of the SEC and CFTC over derivative investment products should be consolidated. Just as banks and savings and loan associations are offering essentially interchangeable products to retail depositors and home mortgage borrowers, broker-dealers and futures commission merchants are offering similar products to the public.

Considerations of efficiency have implications for the development of substantive as well as jurisdictional rules for regulatory agencies. The money market fund phenomenon, the expanded powers of thrift institutions, and the evolution of new insurance products have caused a substantial portion of the transaction account deposit base to be transferred outside the commercial banking system.<sup>206</sup> Because investment managers of money market funds, savings and loan associations, and insurance companies are not subject to the Glass-Steagall Act,<sup>207</sup> considerations of efficiency led to the union of corporate affiliates engaged in traditional banking functions, such as deposit taking and consumer loans, with other affiliates engaged in investment banking. If investment banking has not proven dangerous for these depository institutions, then the underlying premise of the Glass-Steagall Act, that association with invest-

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206. See, e.g., LaFalce, *Banking in the Eighties*, 37 BUS. LAW. 839 (1982) (discussion of growth in assets of money market funds). The authorization for savings and loan associations to engage in new demand deposit activities is set forth at 12 U.S.C. § 1464(b)(1)(A) (1982).

207. See also the proposal of the FDIC to allow state nonmember banks to engage in securities activities. *Unsafe and Unsound Banking Practices*, 48 Fed. Reg. 22,155 (1983) (to be codified at 12 C.F.R. pt. 337)(proposed May 17, 1983). The basis of the FDIC's proposal is a determination that "it is not unlawful under the Glass-Steagall Act for an insured nonmember bank to establish or acquire a bona fide subsidiary [engaging] in securities activities nor for an insured nonmember bank to become affiliated with a company engaged in securities activities." *Id.*

ment banking is dangerous for banks, would seem to be mistaken.<sup>208</sup>

2. *Flexibility.*—Flexibility in regulation is the ability of a regulatory system to adapt to changes in the regulated industry without distorting the regulatory system, the industry, or the marketplace generally. The goal of regulatory flexibility extends beyond regulatory efficiency, responsiveness, and innovation, and includes the desirability of permitting market participants to respond to competitive forces in the most efficient way. The lack of flexibility is the major problem in financial regulation today and the need for flexibility is the basis of the desire for functional regulation.

As we noted earlier, the fundamental premise of the current system is that there are different kinds of financial institutions that perform different functions and therefore ought to have different regulators. That premise is no longer valid. Virtually all large financial institutions today think of themselves as, at least in part, in the business of providing investment management services to their customers. Some of those services have special characteristics, such as transaction powers, that carry special regulatory implications, but the fact remains that they are all competing for the same retail savings dollar by offering similar services. One can see this development clearly in adaptive reorganizations at major banks aimed at combining all services rendered to individuals, including “banking,” “investment management,” and recently, “brokerage,” into self-contained personal banking groups.<sup>209</sup>

3. *Fairness.*—The objective of dealing fairly with investors and depositors seems almost too obvious to include in a list of regulatory goals. One need not look far, however, to realize what a minor role fairness has played in the development of our current system.<sup>210</sup> Fairness to all consumers buying similar financial products requires that comparable rules be applied regardless of the nature of the institutions providing the products.

4. *Safety and Soundness.*—There is no more important or difficult part of the debate over the shape of the future regulatory structure than a discussion of the need to provide safety and soundness.<sup>211</sup> Nor is there

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208. The simple fact is that the Glass-Steagall Act was a response to particular historical conditions. See, e.g., J. BROOKS, *ONCE IN GOLCONDA: A TRUE DRAMA OF WALL STREET 1920-1938*, at 149 (1969).

209. See, e.g., Brinson, *First Chicago's Reorganization Presents Opportunities for Investment Management Group*, 122 TR. & EST., June 1983, at 46.

210. See, e.g., *supra* notes 126-47 and accompanying text.

211. For a thorough discussion of the rationale behind solvency regulation and some

any other aspect of the debate in which the depth of contemporary understanding seems so inadequate. Discussions of this issue frequently fail to distinguish between several discrete concepts that are best considered individually.

First, it is essential to be clear about which questions present true safety and soundness issues and which questions merely echo parochial interests. For example, the underwriting of corporate securities may expose bank capital to new risks; managing mutual funds does not.

Second, it is important to understand the link between protecting individual depositors and protecting the financial system itself. From the perspective of financial institutions, safety and soundness considerations mean that a regulatory system should prevent institutional failures when harm to the financial marketplace would result. In theory, that goal is achieved by protecting small depositors with deposit insurance and permitting market forces to govern the flow of large, uninsured deposits. In practice, however, large banks have become so dependent upon uninsured deposits that the "confidence" of the uninsured, institutional investor has provided the link between deposits at an individual bank and the stability of the financial system as a whole. The travails of Continental Illinois have made that clear.<sup>212</sup> Indeed, uninsured deposits are the most volatile because they are controlled by professionals and because they are so large their withdrawal tends to have the greatest impact on the financial system. Thus, in practice, the FDIC has been compelled to operate the system to protect uninsured as well as insured deposits.<sup>213</sup>

The SEC has been taking steps to encourage a higher level of disclosure of problem loans by bank holding companies<sup>214</sup> in the belief that continuous disclosure will reduce the "run on the bank" effect of a sudden disclosure of serious problems. In turn, the FDIC has considered experimenting with variable, risk-related premiums for deposit insur-

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alternative regulatory approaches, see Edwards & Scott, *Regulating the Solvency of Depository Institutions: A Perspective for Deregulation*, in *ISSUES IN FINANCIAL REGULATION* 65 (F. Edwards ed. 1979).

212. See generally *Continental Requires Large Capital Infusion, With or Without FDIC Help*, 42 WASH. FIN. REP. (BNA) 1022 (June 18, 1984).

213. See, e.g., *Regulators, Banks Put Together Rescue Package for Continental Bank*, 42 WASH. FIN. REP. (BNA) 847 (May 21, 1984). As part of the financial assistance package to Continental Illinois, the FDIC gave its assurance that "all depositors and other general creditors of the bank will be fully protected and service to the bank's customers will not be interrupted." *Id.*

214. See, e.g., *Final SEC Amendment to Guidelines on Bank Holding Company Disclosures*, [July-Dec.] SEC. REG. & L. REP. (BNA) No. 33, at 1629 (Aug. 19, 1983); see also Slater, *New Disclosure Rules Worry Lenders*, *Am. Banker*, Nov. 3, 1983, at 1, 3; McCue, *Groups Speak Out Against Revision of Disclosure Rules*, *Am. Banker*, July 26, 1983, at 3.

ance.<sup>215</sup> It is doubtful that either approach can cope with problems of the scale of Continental Illinois.

Third, it is important to assess the effect deregulation has had on the soundness of the banking industry. Industry officials predict that the problems of Continental Illinois will cause Congress to move slowly on deregulation.<sup>216</sup> Yet it is clear that when major banks have found themselves in trouble in recent years, it has been because of traditional banking activities—real estate loans,<sup>217</sup> energy loans,<sup>218</sup> loans to developing countries,<sup>219</sup> and government securities activities<sup>220</sup>—not because of securities transactions or other exotic activities. It is true that the deregulation of deposit interest rates<sup>221</sup> has made the business of asset and liability management much more complicated and difficult, but that, after all, is the traditional business of banking. While it may be possible to regulate that traditional business more closely and effectively, it is doubtful that government scrutiny can fully protect against bad business judgment. Perhaps, for that reason, the current thinking of bank regulators has been to increase capital requirements to create a larger cushion against losses.<sup>222</sup>

Fourth, significant questions exist regarding the advisability of insurance for nonbank financial institutions. Insurance is currently provided for savings institutions, securities firms, and many insurance

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215. See *FDIC's Proposed Legislation to Improve Deposit Insurance System, and FDIC Analysis*, 42 WASH. FIN. REP. (BNA) 925 (May 28, 1984) (text and FDIC's analysis of the Federal Deposit Insurance Improvements Act of 1984, S. 2699, 98th Cong., 2d Sess.). Section 6 of this bill amends section 7(d) of the Federal Deposit Insurance Act (12 U.S.C. § 1817 (1982)) to give the FDIC flexibility in setting the assessment credits returned to insured banks by basing the credits on the risks the banks present to the Permanent Insurance Fund.

216. *Continental Illinois Changes Legislation Outlook*, BANKING EXPANSION REP., June 4, 1984, at 14; Ferris, *The Aftermath of Continental*, Am. Banker, Aug. 13, 1984, at 1; Rose, *Assessing Continental's Costs*, Am. Banker, July 30, 1984, at 1.

217. See, e.g., Ross, *Nation's Largest REIT Defaults on Due Notes*, The Washington Post, May 6, 1978, at E2, col. 4; see also *Canada Bank Gets Fed Approval to Buy Up Westlands*, Am. Banker, June 14, 1984, at 30.

218. See, e.g., *Three Continental Execs Violated Bank Ethics Code in Oil Deals*, Am. Banker, Feb. 14, 1984, at 3.

219. See, e.g., *Strict U.S. Ruling to Slash Profits of Banks That Lent to Argentina*, N.Y. Times, June 19, 1984, at A1, col. 1; Carrington & Hertzberg, *Financial Institutions are Showing the Strain of a Decade of Turmoil*, Wall St. J., Sept. 5, 1984, at 1, col. 6.

220. See, e.g., *Chase's Battle to Catch Up*, BUS. WEEK, Apr. 9, 1984, at 74.

221. The Depository Institutions Deregulation Act of 1980, 12 U.S.C. § 3503 (1982), authorized a phase out of the ceilings on the maximum rates of interest and dividends that could be paid on deposits.

222. See *Fed Proposes New Capital Guidelines in Break From FDIC and OCC Actions*, 43 WASH. FIN. REP. (BNA) 168 (July 30, 1984); *FDIC Proposes Mandatory Capital Rule; Fed and OCC Expected to Follow*, 43 WASH. FIN. REP. (BNA) 97 (July 16, 1984); *Minimum Capital Standard For All Banks Under Consideration by FDIC*, 42 WASH. FIN. REP. (BNA) 794 (May 15, 1984).



companies,<sup>223</sup> although the insurance system for insurance companies is inadequate. It is clear that the failure of firms other than depository institutions can have a major effect on the financial markets. The impact of the collapse of Penn Central on the commercial paper market and of the attempt of Hunt family interests to corner the silver market a few years ago are good examples.<sup>224</sup> The matter of brokered deposits,<sup>225</sup> which has pitted brokers, as well as the securities industry generally, against the FDIC and the FHLBB, is a good example of the consequences of a fragmented approach to safety and soundness issues. The FDIC and the FHLBB issued rules that would have limited the insurance coverage afforded deposits placed by or through a broker with an insured bank or savings and loan association to \$100,000 per deposit broker.<sup>226</sup> Subsequently, a federal judge declared these rules to be "unlawful and void" and stated that the FDIC and the FHLBB lacked authority to deny or limit insurance to particular categories of deposits.<sup>227</sup>

Finally, the effectiveness of dealing with risky activities by isolating them in separate subsidiaries of bank holding companies must be carefully assessed. While there are some regulatory benefits to be derived from this approach, in the end it is merely an attempt to substitute procedure for substance.<sup>228</sup> Separate subsidiaries will not fully isolate financial intermediaries from the more risky activities of the holding

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223. The roles of the Securities Investor Protection Corporation (SIPC) and of various state funds to protect policyholders in the event of insurance company failure are not as well-publicized as those of the FDIC and FSLIC.

224. As William M. Isaac notes in *Who Should Supervise the Banks?*, Wall St. J., Jan. 16, 1984, at 22, col. 3, the silver market collapse and the Penn Central bankruptcy are often cited by the Federal Reserve Board in support of its argument that it must be given "adequate leverage in shaping the system" if it is to be called upon to "pick up the pieces in a financial crisis."

225. See generally *FDIC Adopts Brokered Deposit Rule; Calls Senate Provision Ineffective*, 43 WASH. FIN. REP. (BNA) 29 (July 9, 1984) (discussing the FDIC regulation that requires banks to report deposits received from money brokers or other federally insured depository institutions); *Legislation To Curb Brokered Deposits Regulations Introduced*, 42 WASH. FIN. REP. (BNA) 901 (May 28, 1984) (discussing bills introduced in Congress to limit the amount of short-term brokered deposits that a federally insured depository institution may accept).

226. The proposed rules were set forth at 49 Fed. Reg. 2787 (1984) (proposed Jan. 23, 1984).

227. *Judge Overturns U.S. Order Meant to End Federal Insurance for Brokered Deposits*, Wall St. J., June 21, 1984, at 2, col. 3.

228. Professor Robert C. Clark has suggested that:

The most basic reason for the separation theme [is that,] absent countervailing considerations, intermediary businesses ought to be kept separate from other lines of business in order to facilitate the regulators' task of achieving soundness. Regulators can create cheaper, simpler, and more uniform reporting and recordkeeping requirements, accounting rules, examination procedures, and substantive risk-related rules if they do not have to contend with the possible impact on the intermediary business of other operations of the regulated entity.

Clark, *The Regulation of Financial Holding Companies*, 92 HARV. L. REV. 789, 815 (1979).

company affiliates. In the event of the bankruptcy of a complex company, the use of separate subsidiaries does not necessarily protect individual units or subsidiaries from the effect of financial problems elsewhere in the company—especially when public confidence in the intermediary is an essential element of each unit's viability. A recent example is the impact of adverse publicity about the problems of Baldwin-United Corporation on the level of sales and redemptions of Single Premium Deferred Annuities issued by its life insurance subsidiaries.<sup>229</sup>

5. *Avoiding Concentration of Power.*—Yet another regulatory goal is avoiding excessive concentration of power within a small group of financial institutions. To some extent this goal reflects the populist distrust of the power of large banks which underlies many of the debates about deregulation of financial markets. We are not entirely free, of course, to choose the size of our financial institutions. They compete in worldwide markets and the players in those markets are very large indeed.<sup>230</sup> In any case, the size of financial institutions is less important than the maintenance of the competition which results from broad access to financial services and to sources of credit. Regulation along functional lines will not reduce such competition and may well have the opposite effect. The more flexibility institutions have in offering different kinds of services to capital suppliers, the more vigorous should be the competition for that capital.

In raising capital, the business of underwriting corporate securities has become significantly concentrated in terms of dollar volume, with the top five firms accounting for over seventy percent of the business.<sup>231</sup> Under rule 415 and other developments, that business has come to require large amounts of capital, thereby placing smaller investment firms

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229. *Baldwin-United is Now Facing Debenture Woe*, Wall St. J., Mar. 31, 1983, at 6, col. 1; *How Baldwin-United Expanded from Pianos to Finance to Trouble*, Wall St. J., Mar. 28, 1983, at 1, col. 6.

230. As of March 31, 1984, Citicorp had assets of \$141.8 billion; BankAmerica, \$121.5 billion; Chase Manhattan, \$81.8 billion; Manufacturers Hanover, \$64.8 billion; and J.P. Morgan, \$59.8 billion. *World Banking Survey: Part I*, Financial Times, May 21, 1984, § III, at VIII, col. 6 table (U.S. Banking: First Quarter, 1984). As of the quarter ending January 31, 1984, the Royal Bank of Canada had assets of C\$83.5 billion and the Canadian Imperial Bank of Commerce had assets of C\$68.0 billion. *Id.* at IX, col. 2 table, (Performance of Five Major Canadian Banks). As of December 31, 1983, Deutsche Bank, Dresdner Bank, and Westdeutsche Landesbank Girozentrale had balance sheet assets of DM 210.0 billion, DM 160.8 billion, and DM 139.4 billion, respectively. *West Germany: Banking, Finance and Investment*, Financial Times, July 5, 1984, § IV, at II, col. 1 table, (Top 10 West German Banks).

231. Salomon Brothers, Merrill Lynch, and Goldman Sachs occupied the top three underwriting positions in fiscal 1983 both in dollar volume and in number of issues, and all three were among the five most heavily capitalized investment banking firms. *Super League Starts to Stretch Away*, Financial Times, June 4, 1984, § III, at VII, col. 1.

at a competitive disadvantage.<sup>232</sup> The addition of large commercial banks as competitors for investment banking firms might well, therefore, be pro-competitive. As for the availability of bank credit, there is little evidence of increasing concentration. There is vigorous international competition for the business of large borrowers, and the number of different kinds of lenders serving the retail credit market continues to multiply.

6. *Implementation of Monetary Policy.*—Finally, any regulatory system must preserve the Federal Reserve Board's authority and ability to implement monetary policy.<sup>233</sup> That should not require the whole deposit base to be put back in "banks," but we must ensure that changes do not make an already inexact process more difficult.

## V. FUNCTIONAL REGULATION

Regulation by institutional type, historically viewed as a simpler and more effective regulatory paradigm than functional regulation, is an approach that worked reasonably well only as long as one could readily distinguish between banks, insurance companies, investment companies, and other financial institutions. If clear and meaningful distinctions along institutional lines can be drawn, then powerful considerations—especially the ease of defining an agency's jurisdiction and of determining the applicability of its rules and regulations—favor regulation by institutional type. Today, however, banks, insurance companies, investment companies, and securities firms often perform similar functions and promote similar products.

In this setting, functional regulation provides a mechanism both for creating a "level playing field" for entities performing similar functions, and for achieving the regulatory goals discussed above. As Federal Reserve Chairman Paul Volcker emphasized before the Senate Banking Committee during its consideration of the legislation that eventually was enacted as the Garn-St.Germain Act, "[i]nstitutions providing the same services should be subject to substantially the same regulations in providing these services, regardless of their form of organization. A number of the distortions and inequities in financial markets today result from failure to adhere to this principle."<sup>234</sup>

There are six primary financial service functions which should be

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232. *Id.*

233. For an excellent discussion of the Federal Reserve's functions in the implementation of monetary policy, see generally P. MEEK, U.S. MONETARY POLICY AND FINANCIAL MARKETS (1982).

234. *Financial Institutions Restructuring and Services Act of 1981: Hearings on S. 1720 Before the*

regulated by similar rules regardless of the type of financial institution performing the functions. They are sales, investment management, intermediation, custodial services, market activity, and lending. As the discussion below suggests, uniformity of treatment is far more attainable with some functions than with others.

### A. Sales

As bank accounts, mutual funds, annuities, and other financial products come to compete in the same maturity spectrums for the same retail savings dollars, the argument for subjecting the marketing of those products to uniform regulation becomes quite strong. Regulation of the sales function should address two issues: adequate disclosure by issuers, and fairness by brokers and other financial services marketing personnel.

1. *The Role of Disclosure.*—Historically, banks have not been required to disclose material facts about their financial condition to retail depositors because deposit insurance removed any “investment” aspect of the deposit instruments. There is surely a positive value in maintaining a system in which individual depositors do not feel compelled to make investment decisions about their short-term balances. The protection offered by deposit insurance has allowed the individual to place modest resources in the financial marketplace without the need for informed credit analysis.

Individual accounts and CDs of less than \$100,000, however, are becoming an increasingly less significant portion of the liabilities of large commercial banks. Large financial institutions have come to rely primarily on purchased funds, including the sale of large CDs in the United States and Eurodollar capital markets, and on repurchase agreements, federal funds, and the like.<sup>235</sup> Such instruments, regardless of their term, are nothing more than debt securities and, in principle, there seems to be no reason why the issuers and secondary markets should be subject to a different set of disclosure requirements than those applicable to nonbank issuers of debt securities.

Traditionally, it has been argued that the federal government cannot permit a major bank to fail because of the degree of economic interdependence in the financial system, and that accordingly, the credit of the United States stands behind all depositors, large and small.<sup>236</sup> Thus, it has been said, there is no need for a system of continuous disclosure

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*Comm. on Banking, Housing, and Urban Affairs*, 97th Cong., 1st Sess. 443, 450 (1981) (prepared statement of Paul Volcker, Chairman, Board of Governors of the Federal Reserve System).

235. M. STIGUM, *THE MONEY MARKET* 68-69 (rev. ed. 1983).

236. See generally Edwards & Scott, *supra* note 211.

because even the purchasers of uninsured CDs were protected. That approach seems to have been borne out by the response of the federal government to the disclosure of huge problem loans at Continental Illinois.<sup>237</sup>

Another traditional reason for nondisclosure has been the avoidance of "runs on the bank" which could result from disclosure of adverse events. But there has been increasing skepticism about the continuing value of the nondisclosure approach in the case of large commercial banks. This skepticism appears to be shared by the Federal Reserve Board, the Comptroller of the Currency, the FDIC, and the SEC.<sup>238</sup>

Certainly, the Continental Illinois experience has shown that delaying disclosure does not prevent runs on the bank—and the delay may make the final "shock loss" even worse.<sup>239</sup> Continental Illinois represented a serious failure of the regulatory system for which there may be no real solution. There was an extraordinary accumulation of bad loans, perhaps in the area of \$5 billion, and the resulting run on the bank was quite serious. If large depositors had not been promised full protection, the impact of withdrawals could have been disastrous.<sup>240</sup> In the end, there were no acceptable ready purchasers for the bank, and, therefore, a huge federal equity investment was required.<sup>241</sup>

Prior to the problems at Continental Illinois, and in response to concerns about disclosure relating to rescheduling and possible default on commercial debt owed to financial institutions by foreign countries, the Federal Reserve Board, the Comptroller of the Currency, and the FDIC jointly proposed a five-point program of regulation.<sup>242</sup> That pro-

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237. See *Regulators, Banks Put Together Rescue Package For Continental Bank*, 42 WASH. FIN. REP. (BNA) 847, 847 (May 21, 1984).

238. See, e.g., Proposed Revision of Industry Guide Disclosures for Bank Holding Companies, 48 Fed. Reg. 18,826 (1983) (to be codified at 17 C.F.R. pts. 231, 241) (proposed Apr. 26, 1983).

239. See generally *Treat Small Banks, Continental Similarly*, Am. Banker, May 31, 1984, at 4 (run on Continental Illinois followed FDIC's announcement of a "modified payoff" policy).

240. In September 1984, Comptroller of the Currency C.T. Conover testified before Congress that, had the federal government not interceded to prevent Continental's failure, "we would have seen a national, if not an international, financial crisis. The dimensions were difficult to imagine. None of us wanted to find out." *Continental Jeopardized Many Banks*, The Washington Post, Sept. 20, 1984, at D1, col. 2.

241. The assistance package to Continental Illinois included "an immediate infusion of \$2 billion in capital in the form of subordinated debt from the Federal Deposit Insurance Corporation and a group of commercial banks." *Regulators, Banks Put Together Rescue Package for Continental Bank*, supra note 237, at 847. A standby facility of \$5.3 billion was also arranged through a consortium of 24 major banks. *Id.*

242. FEDERAL RESERVE, FDIC, & COMPTROLLER OF THE CURRENCY, JOINT MEMORANDUM: PROGRAM FOR IMPROVED SUPERVISION AND REGULATION OF INTERNATIONAL LENDING (Apr. 7, 1983).

gram involved: (a) a stricter examination of country exposure, including higher capital-to-loan ratios for banks with greater concentrations of country exposure; (b) more public disclosure of the country exposure of banks; (c) the specification of new loan classifications: loss, reservable, and debt-service impaired, with requirements for write-off or provisions for reserves in the first two cases; (d) stretch-out of reported income from loan fees; and (e) increased cooperation with bank regulators abroad, possibly including a greater sharing of International Monetary Fund information.<sup>243</sup>

While that proposal seems a little anemic in view of the hemorrhage of deposits at Continental Illinois, it is probably on the right track. Higher capital requirements, earlier write-offs, and earlier disclosure may be the only effective means of preventing such incidents. Some of the negative market response to the sudden disclosure of a financial institution's difficulties can be attributed to the unexpected surprise associated with unfavorable information. Surprise would be minimized under a rule of constant or periodic disclosure. If disclosure were a continuous process, large depositors could adjust to unfavorable information by gradually reducing the flow of deposits to troubled institutions.

2. *Regulation of Sales Practice.*—The transformation of retail bank instruments into investment products is a recent phenomenon. The first event of significance was the shortening of investors' time horizons due to the inflationary cycles of the 1970's and early 1980's. Because of inflationary expectations, investors sought to place an increasing proportion of their savings in short-term instruments, like money market funds,<sup>244</sup> which were directly competitive with bank deposits. Second, the inflationary pressures and volatile economic conditions of the late 1970's forced banks to change their view of the proper way to handle the intermediation function. Borrowing short and lending long was no longer perceived as an appropriate way to conduct the business of banking. Increasing pressure to match the maturities of assets and liabilities, coupled with the steady lengthening of asset maturities, required banks to lengthen the maturity of their liabilities, producing pressure for longer term retail CDs. These factors have contributed to the development of deposit instruments which compete directly with investment instruments. One clear example is the active involvement by banks in the

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243. *Id.*

244. See *Mutual Fund Assets Up 70%*, Am. Banker, Dec. 31, 1981, at 7 (the assets of money market funds rose from \$77 billion in 1980 to \$187 billion in 1981).

merchandising and funding of Individual Retirement Accounts (IRAs), which are long-term savings instruments.

As noted above, conventional wisdom has held that insured retail bank deposits of less than \$100,000 should not be regulated as "investments" because there is no credit risk. It is important to remember, however, that regulation of sales practices is concerned with far more than simply disclosure of credit risk. Notions of suitability, of fair evaluation of competing alternatives, and of avoiding misleading sales practices are as appropriate for many bank and insurance products as they are for stocks and bonds. Yet there is no question that different standards have been applied to different types of financial institutions. The "how to become a millionaire" ads that characterized bank advertising for IRA products in 1982 should be contrasted with comparable ads for mutual fund IRA products, which are subject to SEC scrutiny.

### *B. Investment Management*

Historically, different approaches were developed for the regulation of investment management functions depending upon whether the manager was an insurance company, bank, trust company, or investment adviser, and upon whether a pension fund was involved. In each case, the principal regulatory concerns were the same: avoiding conflicts of interest, enforcing fiduciary obligations, and ensuring fairness of sales practices.

Many insurance company variable account products have been assimilated into the Investment Company Act structure. Most commingled products offered by banks, however, whether for individual trusts or commingled pension fund assets, are exempt from SEC regulation, while analogous nonbank products are not. The regulatory ground rules should be the same regardless of the managing entity. There is no reason why an independent investment manager who manages assets of pension funds and other institutions should be regulated by the SEC while such a manager working for a bank is not. Both should be subject to the same rules governing advertising and fiduciary obligations.

### *C. Intermediation*

The historical distinction between intermediation and investment management is based on allocation of risk: only through the latter process does the customer retain the primary risk of loss. In view of this distinction, only intermediation has been regulated to ensure safety and soundness. Today, however, banks float the return on money market accounts with market rates, and many insurance products permit the insurer to change the returns periodically. It seems clear that the varia-

bility or "equity" nature of these returns does not make the bank or insurance company less of an intermediary for which safety and soundness regulation is appropriate. An intermediary may offer "equity products," and if it does, then many of the investment management rules should apply to it. But if the assets managed are legally the property of the manager and are available to the manager's creditors, then regulation as an intermediary is also appropriate.

The money market fund pushed this traditional distinction to the limit. The fund is an equity product, and the assets are plainly not the property of the investment manager. But just as plainly, when over \$220 billion of the deposit base moves out of banks and into money market funds,<sup>245</sup> much of it subject to at least rudimentary checking powers, something new has happened. As so often occurs in the financial services industry, however, the regulatory system adapted to accommodate this hybrid. In order to compete with banks, money market funds sought permission from the SEC to quote their shares at a stable net asset value of one dollar per share—distinctly not an "equity product" way to value the shares of an investment company. The SEC, whose regulatory domain extends to the valuation of investment companies' net assets, responded by regulating the quality of the asset base of money market funds, although technically it lacked authority to do so. The SEC informed the money market funds that if they wished to value their shares at a stable net asset value—which implies that portfolio investments will be held to maturity and few losses will be realized—then they would be required to confine their investments to both high quality assets and short average maturities.<sup>246</sup> The result has been a fairly high degree of ad hoc safety and soundness regulation, lacking only federal "deposit" insurance.

Intermediation is the area in which uniformity of regulation fits least comfortably. Differences between the asset and liability structures of banks, savings and loan associations, investment companies, and insurance companies have resulted in varied approaches to the regulation of the soundness and capital adequacy of these institutions. In the case of banks, for example, reserve requirements, capital adequacy requirements, and loan ceilings for single borrowers are among the require-

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245. Gross, *Visa Halts Plans for Money Fund*, *Am. Banker*, Dec. 1, 1982, at 1 (quoting statement of Visa U.S.A.).

246. SECURITIES AND EXCHANGE COMM'N, RELEASE NO. IC-13380, VALUATION OF DEBT INSTRUMENTS AND COMPUTATION OF CURRENT PRICE PER SHARE BY CERTAIN OPEN-END INVESTMENT COMPANIES (July 11, 1983) (Money market funds).



ments imposed by the federal regulators to ensure institutional safety and soundness.<sup>247</sup>

Investment companies, although chartered under state law, are regulated by the SEC under the Investment Company Act, which emphasizes reporting and disclosure, stringent conflict-of-interest rules, and the prevention of fraudulent and unfair sales practices.<sup>248</sup> The Act's primary focus is on the role of outside directors, rather than on regulatory supervision.<sup>249</sup> The Act also emphasizes simple capital structures. As Clark notes, "[investment company] capital structure regulation is so severe that it virtually eliminates worries about investment company soundness in the formal sense of freedom from danger of insolvency: because of the limitations on debt an open-end investment company could hardly ever 'fail' in a discrete sense."<sup>250</sup> The regulatory requirements imposed on insurance companies by state insurance commissioners, on the other hand, strictly regulate investments and disallow certain risky assets.<sup>251</sup>

#### D. Custodial Services

A function somewhat related to both intermediation and investment management is the holding of customer or client funds for safekeeping, either with or without any investment management function.<sup>252</sup> Since the funds remain the property of the customer, the custodian is not an intermediary. Such services only involve safekeeping responsibilities, and therefore are different from intermediation and are separable from investment management. The custodial services function lends itself to a high degree of uniformity in regulation.

247. For example, the Federal Reserve System has issued regulations relating to the reserve requirements of all insured banks (as defined at 12 U.S.C. § 1813(h) (1982)). See 12 C.F.R. §§ 204.1-123 (1984). Also, the Comptroller of the Currency has promulgated regulations controlling the lending limits of unsecured loans. See 12 C.F.R. §§ 32.1-111 (1984). Finally, capital adequacy requirements have been the subject of recent proposals by the Federal Reserve Board, the Comptroller, and the FDIC. See *Federal Reserve Board Proposed Capital Adequacy Guidelines*, 43 WASH. FIN. REP. (BNA) 235 (Aug. 6, 1984); *FDIC Proposed Rule Establishing New Capital Adequacy Level*, 43 WASH. FIN. REP. (BNA) 156 (July 23, 1984); see also *supra* note 222.

248. *E.g.*, 15 U.S.C. §§ 80a-9 to -11, -13, -17 (1982).

249. See, for example, section 10 of the Investment Company Act, 15 U.S.C. § 80a-10 (1982), which sets forth prohibitions on affiliations of the directors of investment companies.

250. Clark, *The Soundness of Financial Intermediaries*, 86 YALE L.J. 1, 9 (1976). 15 U.S.C. § 80a-18(f) (1982) provides that open-end investment companies are not permitted to issue senior securities and that borrowings from banks must meet a 300% asset coverage test.

251. See, *e.g.*, N.Y. INSURANCE LAW § 81 (McKinney 1965 & Supp. 1983) (outlining specific requirements to be met by the reserve investments of a domestic insurer).

252. The basic rule established by the case law is that the relationship between a bank and its depositors is that of debtor and creditor, not of agent and principal. See, *e.g.*, *Kress v. Central Trust Co.*, 246 A.D. 76, 78, 283 N.Y.S. 467, 469 (1935), *aff'd*, 272 N.Y. 629, 5 N.E.2d 365 (1936); *Amsden v. Traders Nat'l Bank*, 182 A.D. 474, 475-76, 170 N.Y.S. 316, 317 (1918); *General Fire Assurance Co. v. State Bank*, 177 A.D. 745, 750, 164 N.Y.S. 871, 874 (1917).

*E. Market Activity*

The function of acting as broker or dealer includes activities on both the organized exchanges and the nonexchange dealer markets. In this area there is a pressing need for consistency. Banks are exempt from registration under the Securities and Exchange Act of 1934 as broker-dealers.<sup>253</sup> They are permitted to engage in at least some brokerage functions,<sup>254</sup> but those are regulated by bank regulators<sup>255</sup> that are themselves questioning the adequacy of this regulatory structure.<sup>256</sup> Similarly, there seems little basis for the different regulatory schemes for financial futures, which are regulated by the CFTC, and financial options, which are within the province of the SEC.<sup>257</sup> Both types of options are used by many of the same customers and serve the same economic functions. Furthermore, there is no good reason why banks should be permitted to act as futures commission merchants but be barred from dealing in options. Finally, it seems no more consistent with safety and soundness considerations for a bank to deal in the highly volatile currency and treasury securities markets than for it to deal in investment grade securities. But if banks are permitted to expand their broker and dealer functions, they should be regulated like other broker-dealers.

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253. 15 U.S.C. § 78c(a)(4)-(5) (1982).

254. 12 U.S.C. § 24 (1982) provides in pertinent part that:

[t]he business of dealing in securities by the [national bank] shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the [national bank] shall not underwrite any issue of securities or stock; *Provided* that the [national bank] may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe.

*See also* 49 Fed. Reg. 15,089 (1984) (to be codified at 12 C.F.R. § 5.52) (rules proposed Apr. 17, 1984, by the Comptroller of the Currency dealing with brokerage activities of national banks). A proposal for conducting brokerage services through separate subsidiaries has been the subject of discussion between the SEC and the comptroller. Albert, *Comptroller Joins Growing Protest Against SEC Plan on Bank Brokers*, Am. Banker, Feb. 17, 1984, at 1.

255. The regulations of the comptroller dealing with securities purchases by banks for their own account are found at 12 C.F.R. §§ 1.1-140 (1984).

256. S. 2851, the proposed "Financial Services Competitive Equity Act," seeks to address some of these concerns, but retains the authority of bank regulators over certain securities activities of banks. The bill allows depository institutions, through nondepository affiliates, to underwrite mortgage-backed securities, commercial paper, and all types of municipal revenue bonds. These activities have been described by Senator Garn as "conservative, safe and sound securities activities which are closely related to the traditional business of depository institutions." [Current] FED. BANKING L. REP. (CCH) No. 1038, at 3-5 (Aug. 24, 1984).

257. *See Ackerman, SEC, CFTC Set Stage for Transformation of Markets*, Legal Times, Feb. 15, 1982, at 36.

*F. Lending*

Interestingly, lending is the area in which functional regulation is the most advanced in terms of uniformity of both regulation and administration. Usury laws,<sup>258</sup> truth-in-lending legislation,<sup>259</sup> margin credit,<sup>260</sup> and similar regulatory systems tend to apply with equal force to all lenders.

## VI. CONCLUSION

Is it necessary to make the effort to create a new paradigm? In our view, the fragmentation in the current regulatory system has become so counterproductive that the creation of a new regulatory paradigm has become essential. When the Federal Reserve Board and the Comptroller of the Currency are at open war over the status of nonbank banks under the Bank Holding Company Act and the Secretary of the Treasury has to make peace by asking for a moratorium,<sup>261</sup> when literally hundreds of billions of dollars of the deposit base flow from banks to money market funds and back to bank money market accounts,<sup>262</sup> and when the CFTC must negotiate with the SEC about whether the CFTC should approve a new futures product for trading,<sup>263</sup> then our nation's regulation of its financial services industry is not being implemented in a way that is consistent with the public interest. It is time to develop a new paradigm for the regulation of financial functions and institutions, not by putting a fresh coat of paint on an old structure, but by starting anew with a regulatory blueprint drafted along functional lines.

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258. *See, e.g.*, The Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 501, 94 Stat. 132, 161 (1980) (codified as amended at 12 U.S.C. § 1735f-7 (1982)).

259. *See, e.g.*, Consumer Credit Protection (Truth in Lending) Act, Pub. L. No. 90-321, 82 Stat. 146 (1968) (codified at 15 U.S.C. § 1601 (1982)).

260. *See, e.g.*, 12 C.F.R. § 220.1-.130 (1984).

261. *See* Comptroller of the Currency, News Release No. NR 83-27 (Apr. 5, 1983); *see also* Fuerbringer, *Regan Urges Delay in Lifting of Banking Industry Barriers*, N.Y. Times, Apr. 7, 1983, at D6, col. 1.

262. *See supra* note 245.

263. *See supra* note 257.