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E Pluribus Unum-Out of Many, One: Why the United States Needs a Single Financial Services Agency

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E PLURIBUS UNUM—OUT OF MANY, ONE: WHY THE UNITED STATES NEEDS A SINGLE FINANCIAL SERVICES AGENCY

ELIZABETH F. BROWN*

ABSTRACT

The United States needs to consolidate the over 115 existing state and federal agencies that regulate banking, securities and insurance firms and their products and services into a single, federal financial services agency; a U.S. Financial Services Agency (“US FSA”). The US FSA would be able to more effectively regulate the U.S. financial services industry than the existing regulatory regime. The current U.S. financial regulatory regime suffers from a range of problems, including an inability to anticipate and plan for future financial crises, an inability by regulators to quickly adapt to market innovations and developments, inconsistent regulations for financial products and firms that are competitors in the market, and the capture of agencies focused on a single sector of the financial services industry by the firms that they regulate. In addition, the U.S. financial regulatory regime is one of the most expensive in the world, costing 12 times more than the United Kingdom’s regime and 86 times more than Germany’s regime. The US FSA would eliminate or significantly reduce these problems, as well as provide more cost effective and transparent regulation of the financial services industry than is available under the current system.

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I. INTRODUCTION

The financial services¹ industry in the United States has undergone profound changes in the past seventy years, but the U.S. regulatory structure for this industry has failed to keep pace with these changes. During the 19th and early 20th centuries, the markets for banking, securities, and insurance products and services and the firms selling these products and services were separate from each other and were local or regional rather than national or international. Today, however, the market for financial services no longer operates in this manner. Financial products, whether they are loans, securities or insurance policies, are increasingly viewed as part of the same market that enables individuals and institutions to price risks.² Not only are banks, securities firms, and insurance companies offering products and services that compete with one another, many of the top financial service companies individually now offer a smorgasbord of financial products and services.³ Every year financial conglomerates⁴ are expanding their shares of

¹ In this article, financial services refers to any of the activities considered financial in nature pursuant to Section 103 of the GLBA, which include banking, securities, merchant banking, and insurance products and services. GLBA, 12 U.S.C.S. § 1843 (2004). This definition of financial services is not universally applied by other organizations. For example, the Basel II Capital Accord excludes insurance activities from the definition of “financial activities” and excludes insurance entities from the definition of “financial entities.” BANKFOR INT’L SETTLEMENTS, BASEL COMMITTEE ON BANKING SUPERVISION, INT’L CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS – A REVISED FRAMEWORK 7 n.5 (June 2004) [hereinafter BASEL II CAPITAL ACCORD].

² Gary Silverman, *Banks Break the Old Boundaries*, FIN. TIMES, Jan. 18, 2002, at 15.

³ The Insurance Information Institute conducted a survey in August 2002 of the top 10 companies, ranked by revenues, in each of the major financial services sectors included in the Fortune 500 (diversified financials, securities, commercial banks, savings institutions, and property/casualty insurance).

the markets for these products and services.⁵ Globalization has transformed the financial services industry and forced U.S. companies within this industry to compete on a national and international basis.

Unfortunately, U.S. regulation⁶ of financial services does not reflect these changes. Instead, the United States maintains a multitude of state and federal agencies that regulate only certain sectors within the financial services industry. The current regulatory structure in the United States is comprised of well over 115 different state and federal regulators, including, among others, the Board of Governors of the Federal Reserve System ("Federal Reserve"), the Office of the Comptroller of the Currency ("OCC"), the

INSURANCE INFORMATION INSTITUTE AND THE FINANCIAL SERVICES ROUNDTABLE, *THE FINANCIAL SERVICES FACT BOOK 9* (2003) [hereinafter *FINANCIAL SERVICES FACT BOOK*]. The survey assessed which institutions offered one or more of the following products: auto/homeowners insurance, life/health insurance, commercial insurance, annuities, asset management/retirement funds, personal banking, securities/investment banking, commercial banking and mortgages/credit cards/personal/business loans. The survey did not distinguish between the "manufacturers" of a product and its "distributors." Nine of the 57 companies offered products in all nine product categories, while 40 of the remaining 48 companies offered products in four or more product categories. *Id.* at 9-12.

⁴ The Basel Committee on Banking Supervision and the Joint Forum on Financial Conglomerates defines financial conglomerates as "any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors." TRIPARTITE GROUP OF BANK, SECURITIES, AND INSURANCE REGULATORS, *THE SUPERVISION OF FINANCIAL CONGLOMERATES* ¶ 36 (July 1995). This article will use this definition when referring to financial conglomerates. Financial conglomerates are distinguishable from "mixed conglomerates," in which groups of commercial or industrial enterprises include a financial institution as part of their structure. *Id.* While mixed conglomerates may raise some of the same regulatory and supervisory issues as financial conglomerates, such concerns are beyond the scope of this article.

⁵ The asset share of the top ten companies in property/casualty insurance grew from 30% in 1995 to 45% in 2001. *FINANCIAL SERVICES FACT BOOK*, *supra* note 3, at vii. The asset share of the top ten companies in life insurance grew from 34% in 1995 to 44% in 2001. *Id.* The asset share of the top ten banks grew from 34% in 1995 to 40% in 2001 and the asset share of the top ten savings institutions grew from 21% in 1995 to 38% in 2001. *Id.* Only in the securities sector did the asset share of the top ten companies decline from 60% in 1995 to 53% in 2001. *Id.* Even so, the number of participants in each sector has declined. The number of commercial banks dropped from over 25,000 prior to World War I to 8,096 in 2001; the number of life insurance underwriters fell from about 2,200 in 1985 to 1,549 in 2000. *Id.* at 1. The number of securities broker and dealer firms decreased from 9,515 in 1987 to 7,029 in 2001. *Id.*

⁶ Unless otherwise indicated, the term "regulation" is used in this article to refer broadly to the ability of agencies to issue rules, to supervise the practices and operations of the entities under their authority, and to enforce laws by bringing civil, criminal, or administrative proceedings. Some commentators emphasize the distinction between an agency's rulemaking authority and its supervisory authority and limit their use of the term "regulation" to an agency's rulemaking authority. *Panel I (Part 2): A Comparative Analysis of Consolidated and Functional Regulation: Super Regulator: Keynote Address the Honorable Peter R. Fisher Undersecretary for Domestic Finance, U.S. Department of the Treasury The Need to Reduce Regulatory Arbitrage*, 28 *BROOK. J. INT'L L.* 455, 455 (2003) [hereinafter *Address by Peter R. Fisher*] (proposing a separation of financial rulemaking authority from supervisory authority and a placing of rulemaking authority into a single, federal regulator while leaving supervisory authority within several agencies).

Office of Thrift Supervision (“OTS”) in the Treasury Department, the National Credit Union Administration (“NCUA”), the Federal Deposit Insurance Corporation (“FDIC”), the Securities and Exchange Commission (“SEC”), the Commodities Futures Trading Commission (“CFTC”), the Office of Federal Housing Enterprise Oversight (“OFHEO”) in the Department of Housing and Urban Affairs, the Securities Investor Protection Corporation (“SIPC”), and the Pension Benefit Guaranty Corporation (“PBGC”), as well as state insurance, banking, and securities regulatory agencies in all 50 states plus the District of Columbia.⁷ No other nation has such a fragmented regulatory regime for its financial services industry.

As a result of this balkanized regulatory structure, U.S. regulators are ill-equipped to handle the current challenges posed by the financial services industry. The U.S. Government Accountability Office (“GAO”) issued a report in October 2004 noting that in almost none of the recent financial crises that it examined did a single existing regulator have the necessary resources, authority or jurisdiction to handle the crisis by itself.⁸ The GAO also noted that the regime of multiple regulatory authorities sometimes hindered the ability of the federal government to identify financial crises in their early stages and to monitor crises once they began.⁹ These crises include the financial aftermath of the September 11, 2001 destruction of the World Trade Center, and the 1998 insolvency of Long-Term Capital Management.¹⁰

The current financial regulatory system is expensive when one compares it to how much other developed nations spend to regulate their financial services firms and when one considers the quality of the regulatory authority being exercised. For example, in 2002, the budgets for the U.S. federal and state banking agencies, other federal financial regulators and the state insurance regulators were 12 times more than the budget of the Financial Services Authority of the United Kingdom (“UK FSA”) and 86 times more than the budget of German Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht or “BaFin”), which is the

⁷ Some states have incorporated the regulation of banks and securities or banks and insurance or all three sectors into one agency. In most cases, each sector may have its own division within this single agency. If one counts only the separate agencies and not the different divisions, then the total number of state agencies regulating financial services totals 110.

⁸ U.S. GOVERNMENT ACCOUNTABILITY OFFICE, REPORT TO THE CHAIRMAN, COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, U.S. SENATE, FINANCIAL REGULATION – INDUSTRY CHANGES PROMPT NEED TO RECONSIDER U.S. REGULATORY STRUCTURE 110 (October 2004) [hereinafter GAO FINANCIAL REGULATION REPORT].

⁹ *Id.*

¹⁰ *Id.*

single financial regulator in Germany.¹¹ It is highly doubtful, however, that the U.S. financial services industry is 12 times more sound than the U.K.'s financial services industry or 86 times more sound than Germany's financial services industry.

To address these challenges, the United States needs to create a single, federal financial services agency, a U.S. Financial Services Agency ("US FSA"), which would be similar to the United Kingdom's Financial Services Authority, to supervise and to more effectively regulate the U.S. financial services industry. To create the US FSA, the existing state and federal agencies that regulate and supervise banking, securities and insurance firms and their products and services, would be consolidated and reorganized. States' attorneys general or other duly authorized officials, however, would retain some ability to enforce the financial laws and regulations promulgated by Congress and the new federal agency. Following the creation of the US FSA, the Federal Reserve Board would continue to be responsible for monetary policy and would continue to operate as the central bank for the United States, but its role as a supervisor and regulator of financial holding companies and banks would be transferred to the new US FSA.

Prior efforts to modernize U.S. financial regulations failed to adequately address the problems inherent in the existing regulatory structure. Congress's last attempt to address some of the major regulatory problems in the financial services area was its enactment of the Gramm-Leach-Bliley Act of 1999 ("GLBA").¹² The GLBA repealed portions of the Glass-Steagall Act of 1933,¹³ the Bank Holding Company Act of 1956¹⁴ and other laws in order to permit banks, securities firms, insurance companies, and other entities engaged in the provision of financial services to become affiliated with one another in order to form financial conglomerates. These types of affiliations allow financial services entities to cross sell each other's products and services.¹⁵ The GLBA, however, did not represent a transformation of the U.S. regulatory regime for financial services. Instead, it merely ratified the dismantling of the barriers between banks, securities firms, and insurance companies that had already begun to take place as a result of the regulations

¹¹ See discussion *infra* Part V. F. and accompanying notes.

¹² Pub. L. No. 106-102, § 1, 107 Stat. 1338 (1999) (codified at scattered sections of 12, 15, 16, 18 U.S.C.).

¹³ The Glass-Steagall Act is the name given to four sections of the Banking Act of 1933, Ch. 89, 48 Stat. 162 (1933). GLBA repealed Section 20 of Glass-Steagall, which prevented any Federal Reserve member bank from being affiliated with an entity principally engaged in securities and Section 33, which banned interlocking managements between Federal Reserve member banks and securities firms. GLBA, 12 U.S.C.S. § 377(a) and 12 U.S.C.S. § 78(b) (LexisNexis 2004).

¹⁴ Ch. 240, 70 Stat. 133 (1956) (codified at 12 U.S.C. §§ 1841-49).

¹⁵ GLBA, § 101, 12 U.S.C.S. § 377 and § 78 (LexisNexis 2004).

issued by the existing state and federal financial service regulatory agencies.¹⁶ The GLBA preserved all of the existing federal and state regulators while making only minor adjustments to their regulatory responsibilities.¹⁷ As a result, the GLBA failed to enact the kind of dramatic changes to the financial regulatory structure that are needed to enable the United States to face the challenges posed by the new financial conglomerates and hybrid financial products.

Recognition of the need to alter the current regulatory regime is growing. The GAO Financial Regulation Report recommended that Congress reconsider consolidating or modifying the existing financial regulatory structure in order to “(1) better address the risks posed by large, complex, internationally active firms and their consolidated risk management approaches; (2) promote competition domestically and internationally; and (3) contain systemic risk.”¹⁸ The GAO suggested that Congress consider adopting one of the following four options to address the problems in the current system:

- Consolidating regulators within each of the banking, insurance, securities and futures sectors to create a single federal regulator for each sector (hereinafter referred to as the “functional consolidation option”);
- Consolidating the regulatory structure into two agencies – one that would focus on the safety and soundness of the financial system and the entities within it, while the other agency would focus on conduct-of-business issues, such as consumer and investor protection, disclosure, and money laundering (hereinafter referred to as the “twin peaks option”);
- Consolidating the regulatory structure into a single financial services regulator (hereinafter referred to as the “single regulator option”); and
- Creating a new agency to deal with the special issues posed by large, complex or internationally active financial services firms while

¹⁶ For example, investment banks attempted to offer products and services similar to those offered by commercial banks when they created products, like money market accounts, that mimicked the features of demand deposits offered by banks and began to invest in nonbank banks, which could make commercial loans like banks but could not accept deposits. Beginning in the 1980s, commercial banks were allowed to offer some investment banking services and to provide insurance. See discussion *infra* Part II.

¹⁷ See discussion *infra* Part II.

¹⁸ GAO FINANCIAL REGULATION REPORT, *supra* note 8, at 19.

retaining all of the other existing financial regulators (hereinafter referred to as the “financial conglomerate agency option”).¹⁹

While the GAO Financial Regulation Report briefly discussed the pros and cons of each option, it did not indicate a preference for one option over another, although it did call the single regulator option the most “radical” of the four.²⁰ Conventional wisdom on the U.S. financial regulatory structure, however, rejects the idea of creating a single, federal agency either on the grounds that it is undesirable because the United States benefits from regulatory competition or that it is politically unfeasible because the United States fears big government and favors federalism.²¹

Nevertheless, the creation of a US FSA would, in fact, be the best solution to the challenges facing the U.S. financial regulatory regime. Each of the other proposed solutions would only perpetuate many of the problems that exist in the regulation of the financial services industry. The US FSA would enable the United States to regulate financial conglomerates and hybrid products more efficiently and effectively than it does at present or than it would be able to do under the other proposed options. Given the important role of the financial services industry in the U.S. economy, eliminating the problems inherent in the current regulatory structure for the U.S. financial services industries would seem imperative if one wants to preserve and enhance the soundness and growth of the U.S. economy.²²

This article will lay out the case for why the United States needs to create a single financial services authority now, before the advent of a financial crisis that completely overwhelms the existing regulatory structure. Part II will briefly describe the contours of the current U.S. financial services regulatory regime. Part III will discuss the major challenges to the financial services industry that the existing regulatory structure is ill equipped to handle. Part

¹⁹ *Id.* at 19-23.

²⁰ *Id.*

²¹ See *Address by Peter R. Fisher, supra* note 6, at 458 (commenting that concentrating power in a single regulatory violates U.S. political tradition); HELEN A. GARTEN, *US FINANCIAL REGULATION AND THE LEVEL PLAYING FIELD* 135-38 (2001) (describing the opposition to a single regulator because of a “preference for federalism, fear of big government and faith in the power of regulatory competition”); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 *YALE L.J.* 2359, 2360 (1998) (arguing that states should play a greater role in securities regulation because of the benefits of regulatory competition).

²² Financial services represented 8.3% of the U.S. gross domestic product (“GDP”) in 2000 and 5.7% of the total U.S. employment for the period from 1999 to 2001. *THE FINANCIAL SERVICES FACT BOOK, supra* note 3, at 5-6. If real estate transactions (e.g. development, mortgages and related services, property sales and rentals) were included in the financial services industry, then financial services would have accounted for almost 20% of the U.S. GDP in 2000. *Id.* at 6

IV will outline one possible structure for the US FSA. Part V will address why the US FSA best meets the challenges facing the U.S. financial services industry. Part VI will analyze the major objections that have been raised against creating a single financial regulator and explain why these objections are either exaggerated or outweighed by the benefits provided by a single financial services regulator.

II. THE CURRENT U.S. REGULATORY REGIME FOR FINANCIAL SERVICES.

A. Current Structure of U.S. Financial Regulation.

The current regulatory structure in the United States governing the financial services industry (banking, securities and insurance) is a hodgepodge of federal and state agencies with overlapping authority. This structure was cobbled together over the past two hundred years, primarily in response to one financial crisis after another.²³ The forces that have created the current regulatory structure in the United States follow a Hegelian dialectic. A financial crisis would occur due to some market failure, which would prompt state or federal legislators to enact laws creating a new agency

²³ For overviews of the evolution of the U.S. financial services industry, see ALAN GART, *REGULATION, DEREGULATION, REREGULATION: THE FUTURE OF THE BANKING, INSURANCE, AND SECURITIES INDUSTRIES* (John Wiley & Sons, Inc. 1994); and *THE FINANCIAL SERVICES REVOLUTION* (Clifford E. Kirsch, ed., Irwin Professional Publishing 1997). For detailed descriptions of the evolution of the U.S. banking system, see Alan Greenspan, *Our Banking History*, Remarks before the Annual Meeting and Conference of State Bank Supervisors, Nashville, Tennessee (May 2, 1998) available at <http://www.federalreserve.gov/boarddocs/speeches/1998/19980502.htm>; BRAY HAMMOND, *BANKS AND POLITICS IN AMERICA FROM THE REVOLUTION TO THE CIVIL WAR* (Princeton University Press 1957); JAMES WILLARD HURST, *A LEGAL HISTORY OF MONEY IN THE UNITED STATES, 1774-1970* (University of Nebraska Press 1973); Jerry W. Markham, *Banking Regulation: Its History and Future*, 4 N.C. BANKING INST. 221, 223 (2000) [hereinafter Markham, *Banking Regulation*]; PATRICIA A., *BANKING LAW MANUAL* 2d (2003); ROBERT V. REMINI, *ANDREW JACKSON AND THE BANK WAR* (W.W. Norton & Company Inc. 1967); and Edward L. Symons, Jr. *The "Business of Banking" in Historical Perspective*, 51 GEO. WASH. L. REV. 676 (1983). For detailed descriptions of the evolution of the U.S. securities sector, see CHARLES R. GIESST, *WALL STREET FROM ITS BEGINNINGS TO THE FALL OF ENRON* (Oxford University Press 2004) and LOUIS LOSS AND JOEL SELIGMAN, *SECURITIES REGULATION* 3D, §1-B-1 (2004). For detailed descriptions of the evolution of the U.S. insurance industry, see SHEILA BAIR, *CONSUMER RAMIFICATIONS OF AN OPTIONAL FEDERAL CHARTER FOR LIFE INSURERS*, 6-9 (2004) available at <http://www.isenberg.umass.edu/finopmgt/uploads/basicContentWidget/8631/bair-cons-ramifications.pdf> [hereinafter the BAIR REPORT]; LAWRENCE M. FRIEDMAN, *A HISTORY OF AMERICAN LAW* 2D., 443 (1985); JAMES M. POTERBA, *THE HISTORY OF ANNUITIES IN THE UNITED STATES* 36 (National Bureau of Economic Research Working Paper No. 6001, April 1997); and Susan Randall, *Insurance Regulation in the United States: Regulatory Federalism and the National Association of Insurance Commissioners*, 26 FLA. ST. U.L. REV. 625 (1999).

to regulate the aspect of the industry that gave rise to the market failure. The financial firms would respond by creating new entities, affiliations or products in order to avoid government regulations. These new entities, affiliations or products would create new market failures, prompting new legislation or regulations on the part of federal or state lawmakers. In many cases, federal and state legislators chose to create new regulatory agencies to deal with financial crises in different segments of the financial services industry rather than expand the jurisdiction of existing regulators. As a result of these historical forces, both the federal government and the state governments ended up regulating banking and securities, the federal government attained primary responsibility for regulating futures, and the state governments maintained primary responsibility for regulating insurance.

For most of U.S. history, U.S. financial regulation predominately was entity regulation. Entity regulation focuses on the type of financial institution and the type of products offered by the institution because distinct financial products were offered by distinct institutions.²⁴ Thus, banking regulators and laws controlled banks and their products, securities regulators and laws controlled securities firms and their products, and insurance regulators and laws controlled insurance firms and their products.²⁵ As a result, when a bank sold securities, its securities sales were regulated by the relevant banking regulator and not by the SEC or the state securities regulators.

In the latter half of the twentieth century, market forces increasingly pushed banks to offer more securities and insurance products and pushed securities and insurance firms to devise new products that were in direct competition with banking products.²⁶ The distinctions between the banking, securities and insurance sectors began to blur because these new financial products were fungible.²⁷ A consumer could choose to open a deposit account with a bank or a money market account with a securities firm. An investor could buy securities through a brokerage firm or a bank. As a result, pressure was brought to bear on Congress to move away from a system based predominately on entity regulation to a system that employed a more functional regulation approach in order to create a level playing field. Functional regulation focuses on regulating based on the type of product being provided, instead of on the type of institution providing the product.²⁸ Under a pure functional regulation scheme, the securities regulators would

²⁴ MCCOY, *supra* note 23, § 12.02[2].

²⁵ *Id.*

²⁶ *Id.* at §12.02[1].

²⁷ *Id.*

²⁸ *Id.* at §12.02[2].

regulate securities regardless of whether they were sold by banks or by securities firms.²⁹

In 1999, Congress finally acknowledged that the old regulatory regime was no longer adequate to handle the challenges posed by the new financial products and services and by the financial conglomerates that provided them and it enacted the GLBA. The GLBA preserved many aspects of the federal and state regulatory structure that had evolved over the past 200 years while repealing most of the laws and regulations that had prevented companies in the insurance, banking and securities sectors from engaging in each other's businesses. As previously noted, the GLBA merely ratified the changes that were ongoing in these sectors and that resulted in the convergence of financial products and services.³⁰ Under the GLBA, the regulatory structure preserves some forms of entity regulation by granting regulatory authority to some agencies based on the institution being regulated,³¹ while in other instances regulatory authority is assigned to an agency based upon the nature or function of the product or service being provided.³²

1. BANKING AND OTHER DEPOSITORY INSTITUTIONS REGULATORY AGENCIES

A. REGULATION OF FINANCIAL AND BANK HOLDING COMPANIES

The GLBA permitted banks, securities firms, insurance companies and other entities engaged in financial services to become affiliated under the umbrella of a financial holding company ("FHC") and to cross sell each other's products.³³ The Act designated the Federal Reserve, which supervises bank holding companies, to become the supervisor for these FHCs.³⁴ A bank holding company may elect to become a FHC, provided that all of its depository institution subsidiaries are well-managed and well-capitalized and have at least a "satisfactory" rating under the Community Reinvestment Act of 1977.³⁵

²⁹ *Id.*

³⁰ MCCOY, *supra* note 23, § 12.02[1].

³¹ For example, the OCC continues to regulate nationally chartered banks, the SEC continues to regulate brokerage firms, and the state insurance commissions continue to license insurance underwriting companies. See discussion *infra* Part II.A.4.

³² For example, under the GLBA, the SEC now regulates the sale of securities by bank broker-dealers. The bank regulators previously had regulated such sales. See *infra* text accompanying notes 81 and 82.

³³ GLBA, § 103(a), 12 U.S.C.S. § 1843(k) (2004).

³⁴ *Id.*

³⁵ COMMUNITY REINVESTMENT ACT OF 1977, 12 U.S.C. § 2901 *et seq.* (2004); GLBA, § 103 (codified at 12 U.S.C.S. § 1843(l) (2004)).

The GLBA specified that FHCs may engage in certain activities that are financial in nature, including securities underwriting and dealing, insurance underwriting, insurance agency activities, and merchant banking.³⁶ A FHC may also engage in any activity that the Federal Reserve, in consultation with the Secretary of the Treasury, determines to be financial in nature, incidental to finance, or complementary to a financial activity, provided that such activity does not pose a substantial risk to the safety and soundness of the FHC.³⁷

Only 12 percent of all of the bank holding companies in existence as of March 31, 2003, have elected to become FHCs.³⁸ In addition, 78 percent of the companies registered as FHCs as of March 31, 2003, had previously been bank holding companies before the enactment of the GLBA.³⁹ Only a few firms that had not previously been affiliated with a commercial bank before the enactment of the GLBA, elected to become FHCs.⁴⁰ Charles Schwab & Co., MetLife and Franklin Resources fall into this category.⁴¹ Many of the largest financial conglomerates have not registered as FHCs, including American Express, Merrill Lynch, American International Group, and Household International.⁴²

Concerns about how the Federal Reserve has operated as the regulator for FHCs appear to have deterred many financial conglomerates from becoming FHCs. Financial conglomerates that grew out of securities and insurance companies note that they currently are subject to fewer restrictions on affiliations than they would be if they became FHCs.⁴³ In addition, they

³⁶ GLBA, § 103 (codified at 12 U.S.C.S. § 1843 (2004)).

³⁷ *Id.*

³⁸ BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM AND U.S. DEPARTMENT OF THE TREASURY, REPORT TO THE CONGRESS ON FINANCIAL HOLDING COMPANIES UNDER THE GRAMM-LEACH-BLILEY ACT 6 (Nov. 2003). Only 630 companies had elected to become FHCs as of March 31, 2003. *Id.*

³⁹ *Id.* at 3.

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² Financial Holding Companies as of August 6, 2004, Federal Reserve Board www.federalreserve.gov/generalinfo/fhc/ (last visited Aug. 12, 2004); THE FINANCIAL SERVICES FACT BOOK, *supra* note 3, at 9. In fact, only two of the top ten companies classified as diversified financials by Fortune have registered as FHCs. Financial Holding Companies as of August 6, 2004, Federal Reserve Board; www.federalreserve.gov/generalinfo/fhc/ (last visited Aug. 12, 2004).

⁴³ Steve Bartlett, *the President and Chief Executive Officer of the Financial Services Roundtable*, commented in his testimony before the Senate Committee on Banking, Housing and Urban Affairs (July 13, 2004):

One of the central features of GLBA was the creation of financial holding companies. . . . The financial holding company structure significantly expanded the scope of activities permissible for banking firms; it did not offer insurance firms and securities firms a similar benefit. Outside of the financial holding company structure, securities and insurance firms are subject

believe that the Federal Reserve lacks the expertise to regulate financial conglomerates with substantial businesses in the investment banking and insurance sectors, because the Federal Reserve has traditionally only regulated commercial banks.⁴⁴

These financial conglomerates are also particularly concerned that the Federal Reserve is slow to approve new products and services for FHCs. These delays may put FHCs in a competitively disadvantageous position compared to other financial conglomerates.⁴⁵ This concern is based on the fact that the Federal Reserve has designated only a few new activities as “financial activities” within the past five years.⁴⁶ From the viewpoint of these financial conglomerates, the failure of the Federal Reserve to permit FHCs to provide real estate brokerage and real estate management services is illustrative. Savings associations and approximately half of the state-chartered banks currently are allowed to provide real estate brokerage and real estate management services to their customers. In January 2001, the Federal Reserve and the Treasury proposed a regulation that would have permitted FHCs and national bank financial subsidiaries to provide such services.⁴⁷ Nevertheless, the Federal Reserve and the Treasury still had not adopted this regulation as of January 1, 2006.⁴⁸

B. REGULATION OF BANKS

Whether an agency supervises and regulates a bank depends upon whether the bank in question has a national charter or a state charter, whether it is a member of the Federal Reserve System, and whether its deposits are insured by the FDIC. National banks are chartered by the Office of the Comptroller of the Currency (“OCC”) and subject to its

to few limitations on affiliations. Thus, it is not surprising that only a handful of securities and insurance firms have become financial holding companies.

Id.

⁴⁴ This issue has been raised by financial conglomerates such as Merrill Lynch and Goldman Sachs, which developed out of traditional investment banks. Silverman, *supra* note 2, at 15.

⁴⁵ Harry P. Doherty, *Vice Chairman of the Board, Independence Community Bank Corp. and First Vice Chairman, Board of Directors, America's Community Bankers, Testimony of America's Community Bankers on An Examination of the Gramm-Leach-Bliley Act Five Years After its Passage before the Committee on Banking, Housing and Urban Affairs of the U.S. Senate* 6 (July 13, 2004).

⁴⁶ *Id.* at 3. See also Bartlett, *supra* note 43, at 10.

⁴⁷ Doherty, *supra* note 45, at 6.

⁴⁸ The Federal Reserve Board, Regulations, Bank Holding Companies and Change in Bank Control, Proposed Amendments to permit financial holding companies to act as real estate brokers and managers, at <http://www.federalreserve.gov/regulations/default.htm> (last visited Jan. 1, 2006).

supervision and regulation.⁴⁹ National banks are also required to be members of the Federal Reserve System.⁵⁰

Well-capitalized and well-managed national banks can own financial subsidiaries that sell insurance or securities.⁵¹ These financial subsidiaries can only engage in financial activities that the bank could engage in directly. Thus, these subsidiaries cannot engage in annuities or insurance underwriting, insurance company portfolio investments, real estate investment or development, or merchant banking.⁵² In addition, a national bank cannot allow the aggregate consolidated total assets of all of its financial subsidiaries to exceed the lesser of \$50 billion or 45 percent of the national bank's consolidated total assets.⁵³ These rules mean that a financial conglomerate does not have to be a FHC or a bank holding company regulated by the Federal Reserve, but can merely be a national bank that owns securities and insurance company subsidiaries, which is regulated by the OCC.

State banks are chartered by individual states and have the option of becoming a member of the Federal Reserve System.⁵⁴ A state chartered bank is supervised and regulated by the banking commission of the state that issued its charter. If the state chartered bank is a member of the Federal Reserve System, then it will be subject to the regulation and supervision of the Federal Reserve.⁵⁵ If the state chartered bank is not a member of the Federal Reserve System, then the FDIC will be its primary federal regulator.⁵⁶ The FDIC also acts as a back-up supervisor for other nationally chartered and state chartered banks, which are insured by the FDIC.⁵⁷

In the years following the enactment of the GLBA, the total number of banks in the United States, both nationally chartered and state chartered, has declined.⁵⁸ In 2003, nationally chartered banks comprised only a little more

⁴⁹ National Bank Act, 12 U.S.C.S. §§ 21, 23, 26, 27 (2004).

⁵⁰ Federal Reserve Act of 1913, 12 U.S.C.S. § 221 (2004).

⁵¹ 12 U.S.C.S. § 24a(a)(2)(C), (g)(5) & (g)(6) (2004). "Well-capitalized" for these purposes is defined as having the same meaning as in section 38 of the Federal Deposit Insurance Act. 12 U.S.C.S. § 1831o (2004). For a bank that has been examined, "well-managed" means that the bank has received a composite rating of one or two under the Uniform Financial Institutions Rating System and at least a rating of two for management. For banks that have not been examined, "well-managed" means that the bank's managerial resources are deemed satisfactory by the appropriate federal banking agency. *Id.*

⁵² 12 U.S.C.S. § 24a(a)(2)(B) (2004).

⁵³ 12 U.S.C.S. § 24a(a)(2)(D) (2004).

⁵⁴ MCCOY, *supra* note 23, §§ 2.03[a], 3.02.

⁵⁵ 12 U.S.C.S. §§ 248, 325, 338, 483 (2004).

⁵⁶ 12 U.S.C.S. § 1831a (2004).

⁵⁷ See 12 U.S.C.S. §§ 1815, 1828 (2004).

⁵⁸ FDIC, Statistics on Depository Institutions, <http://www2.fdic.gov/sdi/index.asp> (last visited September 8, 2005) (click "Enter SDI"; follow hyperlink "Retrieve Predefined Standard Reports"; then run "Standard Report #5"). Between the years 1999 and 2003, the total number of nationally chartered

than 25 percent of the total number of banks in the United States, but held 55.4 percent of the country's total deposits.⁵⁹ In addition to holding more deposits than state chartered banks, nationally chartered banks were, on average, more profitable than state banks in 2003.⁶⁰

C. REGULATION OF SAVINGS AND LOANS AND THEIR HOLDING COMPANIES

The Office of the Thrift Supervision ("OTS") supervises savings and loan holding companies, which are companies that directly or indirectly control a savings association or thrift.⁶¹ The OTS also charters, examines, supervises and regulates federal savings associations that are insured by the Savings Association Insurance Fund ("SAIF") of the FDIC and examines, supervises and regulates state chartered savings associations that are insured by SAIF.⁶² State chartered thrifts are also chartered, supervised and regulated by the state savings and loan commissions that granted them their charters. The FDIC also acts as a back-up regulator for thrifts that are insured by SAIF.⁶³

In 2003, nationally chartered savings and loans comprised 87.8 percent of all of the savings associations in the United States.⁶⁴ In addition, the savings and loan holding companies owned over half of the savings associations in the United States in 2003.⁶⁵ Thrifts on average are as profitable as state banks, although they hold fewer assets than national and

banks declined 15.5 percent to 1999 banks in 2003, while the number of state chartered banks declined 7.1 percent to 5771 banks in 2003. *See id.*

⁵⁹ *See id.*

⁶⁰ *See id.* In 2003, the return on equity for national banks was 16.1 percent, up slightly from 1999 when the return on equity for national banks was 15.1 percent. *See id.* The return on equity for state banks was 13.0 percent in 2003, down 9.7 percent from the 14.4 percent return on equity that state banks had in 1999. *See id.*

⁶¹ OFFICE OF THRIFT SUPERVISION, U.S. DEP'T OF THE TREASURY, 2003 FACT BOOK 72 n.17 (2004) [hereinafter OTS FACT BOOK].

⁶² 12 U.S.C.S. § 1463 (2004).

⁶³ 12 U.S.C.S. §§ 1814-1816 (2004).

⁶⁴ OTS FACT BOOK, *supra* note 61, at 2. The United States had 928 savings associations in 2003, of which 815 had national charters. *Id.*

⁶⁵ *See id.* at 68. Some savings associations may be owned by more than one holding company, which is why there are more holding companies than savings associations that own them. *Id.* at 72 n.17.

state banks.⁶⁶ In 2003, thrifts held assets equal to about 20 percent of the assets held by national and state banks.⁶⁷

D. REGULATION OF CREDIT UNIONS

A dual regulatory system also exists for credit unions. Credit unions may be chartered and regulated either by state authorities or by the National Credit Union Administration (“NCUA”).⁶⁸ The NCUA also contains the National Credit Union Share Insurance Fund (“NCUSIF”), which insures deposits within credit unions.⁶⁹ Credit unions can only serve their members, who generally must share a single common bond based on an occupation or community if the credit union has more than 3,000 members, or may share multiple common bonds if the credit union has less than 3,000 members.⁷⁰ While credit unions share many of the same attributes as banks, they are granted special tax benefits and are exempt from the lending requirements of the Community Reinvestment Act because they serve only a limited group of people.⁷¹

2. INSURANCE REGULATORY AGENCIES

Unlike depository institutions, which are regulated by both the federal and state governments, the insurance business is regulated almost exclusively by the state insurance commissions.⁷² State insurance commissions regulate the products and services offered by insurance companies. All state insurance commissions also license insurance producers, although the exact type of licenses issued varies.⁷³ Some states issue a general insurance producer license while others issue licenses for each different type of producer, such as individual licenses for agents, brokers, solicitors, consultants, and

⁶⁶ Conference of State Bank Supervisors, Number of Commercial Banks by Charter, available at www.csbs.org/info_stats/banks_by_charter.htm (last visited Sept. 8, 2005); THE FINANCIAL SERVICES FACT BOOK, *supra* note 3, at 71. The return on equity for thrifts is similar to the return on equity for state banks. In 2001, thrifts averaged a return on equity of 13.10 percent compared with the 13.14 percent earned by state banks in that year. *Id.*

⁶⁷ THE FINANCIAL SERVICES FACT BOOK, *supra* note 3, at 71.

⁶⁸ 12 U.S.C.S. § 1752 (2004).

⁶⁹ 12 U.S.C.S. § 1783 (2004).

⁷⁰ 12 U.S.C.S. § 1759 (2004).

⁷¹ 12 U.S.C.S. §§ 1768, 2902(2) (2004).

⁷² NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS, 2002 INSURANCE DEPARTMENT RESOURCES REPORT (2003) [hereinafter NAIC 2002 REPORT].

⁷³ *Id.*

reinsurance intermediaries.⁷⁴ In 2002, there were 7,173 domestic insurers and 3.8 million licensed insurance producers in the United States.⁷⁵

3. SECURITIES AND FUTURES REGULATORY AGENCIES

The Securities and Exchange Commission (“SEC”) regulates broker-dealers, investment companies, investment advisors, mutual funds, public utility holding companies, and self-regulatory organizations, including stock exchanges. State securities regulators also regulate broker-dealers and brokerage firms who sell securities within their states as well as investment advisers who manage less than \$25 million.

In order to protect brokerage clients in the event that a brokerage goes out of business, Congress created the Securities Investor Protection Corporation (“SIPC”) in 1970.⁷⁶ SIPC ensures that investors will receive securities that a bankrupt brokerage firm held for their account in street name up to a limit of \$500,000 per customer.⁷⁷ SIPC only guarantees to return the securities. It does not guarantee the value of the securities.

Unlike bank regulators, federal and state securities regulators did not traditionally focus on prudential concerns that would address the stability of the financial system and the solvency of the firms operating within it. Rather, they focused on protecting investors from fraud by requiring disclosure of all material information.⁷⁸ The SEC, however, has become more focused on the prudential concerns of safety and soundness since it has begun to supervise some types of investment bank holding companies. In 2004, the SEC created a new regulatory regime for financial conglomerates comprised of financial service providers that are not affiliated with certain types of banks, such as foreign banks or savings associations, and have a broker-dealer with a substantial presence in the securities markets.⁷⁹ Such financial conglomerates may elect to be supervised by the SEC as supervised investment bank holding companies (“SIBHC”).⁸⁰

The Commodities Futures Trading Commission (“CFTC”) regulates commodity futures and option markets, traders, brokers, futures commission merchants, commodity trading advisors, commodity pool operators, and self

⁷⁴ *Id.*

⁷⁵ *Id.* at 39, 53.

⁷⁶ GART, *supra* note 23, at 75.

⁷⁷ *Id.*

⁷⁸ MCCOY, *supra* note 23, § 12.02[2].

⁷⁹ SECURITIES AND EXCHANGE COMM’N, FINAL RULE: SUPERVISED INVESTMENT BANK HOLDING COMPANIES (CORRECTED VERSION), RELEASE NUMBER 34-49831 (2004), available at <http://www.sec.gov/rules/final/34-49831.htm>.

⁸⁰ *Id.*

regulating organizations such as the National Futures Association.⁸¹ The CFTC also regulates options and futures products and jointly regulates some hybrid products, like single stock futures, in conjunction with the SEC.

4. FUNCTIONAL REGULATION

With a few exceptions, financial products and services continue to be regulated by the agencies that regulated such transactions prior to the adoption of the GLBA. As previously noted, this form of regulation is referred to as functional regulation and is based on the function (or classification) of the type of product or service rather than the institution that provided it.⁸² Under the GLBA, the state insurance commissions regulate the sale of insurance, the SEC and the state securities regulators regulate the sale of securities, the CFTC regulates options and futures, and the federal and state banking regulators regulate banking services and products.

Prior to the enactment of the GLBA, some financial products were regulated based on the classification of the institution providing the product or service and not based on the classification of the product or service being offered. For example, bank regulators had regulated the securities activities of banks rather than the SEC. After the enactment of the GLBA, in keeping with the concept of functional regulation, some of these activities became the responsibility of the functional regulator, while others continued to be regulated based on the classification of the institution offering the product or service rather than the classification of the product or service. The most substantial change wrought by the GLBA in this area was to make many bank securities activities by bank broker-dealers subject to regulation by the SEC rather than by the bank regulators.⁸³ Nevertheless, other bank securities activities, such as commercial paper and exempted securities, private placements, asset-backed securities, derivatives, third-party networking arrangements, trust activities, employee and shareholder benefit plans, sweep accounts, affiliate transactions, and safekeeping and custody services, continue to be regulated by the bank regulatory agencies.⁸⁴

The GLBA also attempted to set up a system for determining which functional regulator should regulate new hybrid products. Section 205 of the

⁸¹ See generally the Commodity Exchange Act, 7 U.S.C.S. § 1 et. seq. (2004), which further outlines the purposes of the CFTC.

⁸² Michael P. Malloy, *Functional Regulation: Premise or Pretext?*, in FINANCIAL MODERNIZATION AFTER GRAMM-LEACH-BLILEY 179, 180 (Patricia A. McCoy ed., 2002). See also GLBA Title II, Pub. L. NO. 106-102, 113 Stat. 1338, 1385 (1999) (codified at scattered sections of 12, 15, 16, 18 U.S.C.).

⁸³ 15 U.S.C.S § 78c (a)(4)-(a)(5) (2004).

⁸⁴ *Id.* § 78c (a)(4)(B).

GLBA defines a “new hybrid product” as one that was not previously defined as a security before the enactment of the GLBA and is not defined as an identified banking product within the GLBA.⁸⁵ The GLBA gave the SEC primary regulatory authority over new hybrid products that the SEC determined were securities. However, the GLBA did require the SEC to consult with and to seek the concurrence of the Federal Reserve before imposing broker-dealer registration requirements in connection with such hybrid products.⁸⁶ The definition for new hybrid product in Section 205 of the GLBA does not mention the possibility of the product being an insurance product nor does Section 205 require the SEC to consult with the state insurance regulators before issuing rules governing hybrid products that may be combinations of insurance and securities products.⁸⁷ Section 104 of the GLBA, however, did reaffirm that the states would retain control over the regulation of insurance products and services.⁸⁸

5. CONSOLIDATION OF STATE FINANCIAL SERVICES AGENCIES

While the federal government enacted changes to the financial regulatory regime with the passage of the GLBA, the states have also been altering the regulatory regime by consolidating state financial regulators. Slightly more than half of the states have either created a single agency that deals with banking, securities and insurance or have created a semi-integrated agency that deals either with banking and securities, banking and insurance or securities and insurance in a single agency.⁸⁹ Thirteen states and the District

⁸⁵ *Id.* § 78o (i)(6)(A) (2004). “Identified banking product” is defined as a deposit account, savings account, certificate of deposit, or other deposit instrument issued by a bank, a banker’s acceptance, a letter of credit or loan made by a bank, a debit account at a bank arising from a credit card or similar arrangement, a participation in a loan which the bank or an affiliate of the bank (other than a broker or dealer) funds, participates in, or owns that is sold to qualified investors or sophisticated investors, or any swap agreement, except for any equity swap sold to a person other than a qualified investor. *Id.* § 78c (a)(4).

⁸⁶ *Id.* § 78o. If the Federal Reserve disagrees with the SEC’s determination that the product is a security and subject to regulation by the SEC, then the Federal Reserve may have the U.S. Court of Appeals for the District of Columbia review the final regulation adopted by the SEC, provided that the Federal Reserve files not later than 60 days after the date of publication of the final regulation a petition with the court requesting that the regulation be set aside. *Id.* § 78o (i)(5). The Court of Appeals must base its determination on whether to set aside the regulation on whether the court finds that the product is a new hybrid product, that the new product is a security, and that imposing a requirement to register as a broker or dealer for banks buying or selling the product is “appropriate in light of the history, purpose, and extent of regulation under the Federal securities laws and under the Federal banking laws” without giving deference to either the SEC or the Federal Reserve. *Id.* § 78o (i)(5)(D).

⁸⁷ *Id.* § 78o (i)(5)(D).

⁸⁸ *Id.* § 6701.

⁸⁹ THE CONFERENCE OF STATE BANK SUPERVISORS, A PROFILE OF STATE CHARTERED

of Columbia have created a single agency to supervise and regulate all financial services.⁹⁰

Below is a table that shows which states still have separate agencies for banking, insurance, and securities, and which have combined the regulation of two or more sectors into a single agency.

BANKING 35 (19th ed., 2003); CAL. DEP'T FIN. INST., ANN. REP. 24 -25 (2002); GA. DEP'T OF BANKING AND FIN., ANN. REP. (2002); HAW. DEP'T OF COM. AND CONSUMER AFFAIRS, ANN. COMPLIANCE RESOL. FUND REP. (2002); IND. DEP'T OF FIN. INST., ANN. REP. 16 (2002); IOWA SUPERINTENDENT OF BANKING, ANN. REP. 27 (2002); MISS. DEP'T OF BANKING & CONSUMER FIN., ANN. REP. 12-14 (2002); N.Y. BANKING DEP'T, ANN. REP. 1 (2002); S.C. STATE BD. OF FIN. INST., ANN. ACCOUNTABILITY REP. (2002); VT. INS. COMM'R, ANN. REP. 10 (2002); WASH. DEP'T OF FIN. INST., ANN. REP. 2 (2002); W.VA. BD. OF BANKING AND FIN. INST., ANN. REP. 14, 18, 23 (2002); State of Illinois Department of Financial and Professional Regulation, <http://www.idfpr.com> (last visited Jan. 1, 2006); Michigan Office of Financial & Insurance Services, <http://www.michigan.gov/cis/0,1607,7-154-10555-40268--,00.html> (last visited Jan. 1, 2006).

⁹⁰ THE CONFERENCE OF STATE BANK SUPERVISORS, A PROFILE OF STATE CHARTERED BANKING 35 (19th ed., 2003); CAL. DEP'T FIN. INST., ANN. REP. 24 -25 (2002); WASH. DEP'T FIN. INST., ANN. REP. 2 (2002); HAW. DEP'T OF COMM. AND CONSUMER AFFAIRS, ANN. COMPLIANCE RESOL. FUND REP. (2002); IOWA SUPERINTENDENT OF BANKING, ANN. REP. 27 (2002); MISS. DEP'T OF BANKING & CONSUMER FIN., ANN. REP. 12-14 (2002); VT. INS. COMM'R, ANN. REP. 10 (2002); State of Illinois Department of Financial and Professional Regulation, <http://www.idfpr.com> (last visited Jan. 1, 2006); Michigan Office of Financial & Insurance Services, <http://www.michigan.gov/cis/0,1607,7-154-10555-40268--,00.html> (last visited Jan. 1, 2006).

States with Either an Integrated or Semi-Integrated Financial Services Agency as of January 1, 2006⁹¹

Single Supervisor for Financial Services	Single Agency Supervising Two Types of Financial Intermediaries			States with a Separate Agency For Banking, Securities, and Insurance Firms
	Banks and Securities Firms	Banks and Insurers	Securities Firms and Insurers	
Alaska Colorado District of Columbia Florida Hawaii Iowa Maine Michigan Minnesota Oregon Rhode Island South Dakota Vermont Virginia	Connecticut Idaho Kentucky Louisiana Montana Nebraska New Mexico Ohio Puerto Rico Washington Wisconsin	Illinois New Jersey Nevada	Tennessee	Alabama Arizona Arkansas California Delaware Georgia Indiana Kansas Maryland Massachusetts Mississippi Missouri New Hampshire New York North Carolina North Dakota Oklahoma Pennsylvania South Carolina Texas Utah West Virginia Wyoming

⁹¹ THE CONFERENCE OF STATE BANK SUPERVISORS, A PROFILE OF STATE CHARTERED BANKING 35 (19th ed., 2003); CAL. DEP'T FIN. INST., ANN. REP. 24 -25 (2002); GA. DEP'T OF BANKING AND FIN., ANN. REP. (2002); HAW. DEP'T OF COMMERCE AND CONSUMER AFFAIRS, ANN. COMPLIANCE RESOL. FUND REP. (2002); IND. DEP'T OF FIN. INST., ANN. REP. 16 (2002); IOWA SUPERINTENDENT OF BANKING, ANN. REP. 27 (2002); MISS. DEP'T OF BANKING & CONSUMER FIN., ANN. REP. 12-14 (2002); N.Y. BANKING DEP'T, ANN. REP. 1 (2002); S.C. STATE BD. OF FIN. INST., ANN. ACCOUNTABILITY REP. (2002); VT. INS. COMM'R, ANN. REP. 10 (2002); WASH. DEP'T OF FIN. INST., ANN. REP. 2 (2002); W.VA. BD. OF BANKING AND FIN. INST., ANN. REP. 14, 18, 23 (2002); State of Illinois Department of Financial and Professional Regulation, <http://www.idfpr.com> (last visited Jan. 1, 2006); Michigan Office of Financial & Insurance Services, <http://www.michigan.gov/cis/0,1607,7-154-10555-40268--,00.html> (last visited Jan. 1, 2006).

While the District of Columbia and most of the 13 states that have a single agency to regulate financial services maintain separate divisions for each financial sector, some of the states have organized their financial services regulator into divisions based upon regulatory goals. Michigan is an example of one of the states that has reorganized its financial regulatory structure to focus on regulatory goals rather than financial sectors.

Michigan, through its Office of Financial and Insurance Services (“OFIS”), claims to be “the first state to coordinate regulation of financial institutions, insurance, and securities industries under the federal Financial Services Modernization Act of 1999.”⁹² Michigan created the OFIS in April of 2000 by combining the Financial Institutions Bureau, the Insurance Bureau, and the Securities Bureau.⁹³ Frank Fitzgerald had been the commissioner of the Michigan Insurance Bureau before becoming the first commissioner to lead the OFIS. He justified the creation of the new office by stating: “The old fire walls are breaking down and the operative word today is convergence. . . . The new office is intended to improve regulatory efficiency.”⁹⁴

Initially, the OFIS had three divisions that essentially replicated the three former bureaus.⁹⁵ Within the past four years, however, the OFIS has reorganized its internal structure so that now it is divided into two offices, the Office of Financial Evaluation, which deals with prudential regulation and supervision, and the Office of Policy, Conduct and Consumer Assistance.⁹⁶ The Office of Financial Evaluation has four divisions: (1) banks and trusts, (2) credit unions, (3) insurance examinations, and (4) supervising and monitoring financially troubled insurance companies.⁹⁷

In the Office of Policy, Conduct, and Consumer Assistance, three of the four divisions deal with more than one financial sector.⁹⁸ The Consumer Services Division acts as the initial point of contact for consumer inquiries and complaints.⁹⁹ The Conduct Review and Securities Division licenses mortgage brokers, securities brokers-dealers, investment advisors, securities agents, insurance agents, and insurance agencies as well as undertaking

⁹² Michigan Office of Financial & Insurance Services, <http://www.michigan.gov/cis/0,1607,7-154-10555-40268--,00.html> (last visited Jan. 26, 2006).

⁹³ MICH. OFF. OF FIN. & INS. SERVICES, ANN. REP. (2000).

⁹⁴ R.J. King, *State to Oversee Financial Firms: Engler Plans to Set Up Regulatory Office to Keep Tabs on Banks, Insurers, Brokers*, DETROIT NEWS, Jan. 28, 2000, at B1.

⁹⁵ MICH. OFF. OF FIN. & INS. SERVICES, ANN. REP., *supra* note 93.

⁹⁶ MICH. OFF. OF FIN. & INS. SERVICES, ANN. REP. 7 (2004).

⁹⁷ *Id.*

⁹⁸ *Id.*

⁹⁹ *Id.*

investigations and enforcement actions under all of the OFIS codes.¹⁰⁰ The Policy Division provides research, policy analysis, and recommendations in support of all regulatory activities and policy development regarding the financial services industry.¹⁰¹ The Health Plans Division regulates HMOs and non-profit healthcare providers.¹⁰²

6. A PICTURE OF THE CURRENT REGULATORY STRUCTURE FROM THE PERSPECTIVE OF A FINANCIAL HOLDING COMPANY.

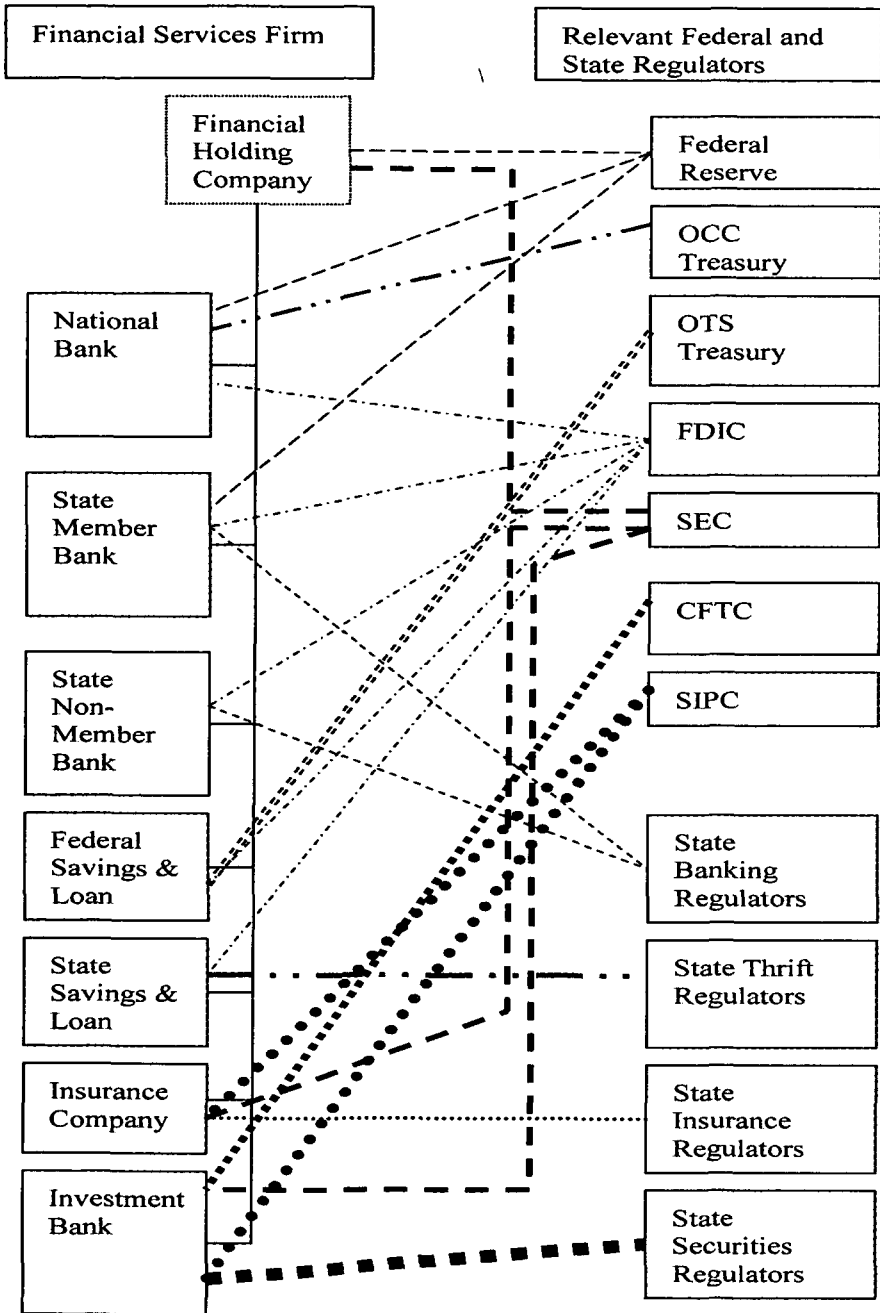
The result of these regulations is that a financial conglomerate that operates in all 50 states, is controlled by a financial holding company and owns a nationally chartered bank, a state chartered bank that is a member of the Federal Reserve System, a state chartered bank that is not a member of the Federal Reserve System, a federal thrift, a state thrift, an investment bank, and an insurance company would, at a minimum, face supervision and regulation from the host of regulators shown in the following diagram.¹⁰³

¹⁰⁰ *Id.*

¹⁰¹ MICH. OFF. OF FIN. & INS. SERVICES, ANN. REP. 7 (2004).

¹⁰² *Id.*

¹⁰³ This picture would be even more muddled if it illustrated which agencies regulated the products and services provided by each entity. For example, many national banks also sell annuities which are regulated by both the SEC and the state insurance commissions.



B. *Prior Proposals to Consolidate Agencies.*

Over the past sixty years, many commentators have noted the problems created by having multiple state and federal financial regulators and have called for the consolidation of the regulators at the federal level. The following are illustrative of the most important consolidation proposals advanced during the past 60 years:

- In 1949, the Commission on Organization of the Executive Branch of Government (the “Hoover Commission”) recommended transferring all of the federal regulatory authority over banks from the OCC and the FDIC to the Federal Reserve.¹⁰⁴
- In 1971, the President’s Commission on Financial Structure and Regulation (the “Hunt Commission”) recommended consolidating banking regulatory responsibilities into three new agencies: (1) the Administrator of National Banks, who would assume the supervisory duties of the OCC, (2) the Administrator of State Banks, who would assume the supervisory duties of the Federal Reserve and the FDIC but leave in place the state banking regulators, and (3) the Federal Deposit Guarantee Administration, which would assume the insurance functions of the FDIC, the FSLIC and the NCUSIF.¹⁰⁵
- In 1975, the House Banking Committee completed a study which recommended the creation of a new federal agency responsible for all federal regulation over state and federally-chartered depository institutions.¹⁰⁶
- In December 1982, the Task Group on Regulation of Financial Services recommended creating a new “Federal Banking Agency” within the Treasury Department that would regulate all national banks and their holding companies while the Federal Reserve would oversee federal regulation of all state-chartered banks and their holding companies. The FDIC’s sole responsibility would be to focus on providing deposit insurance and administering the deposit insurance system. Antitrust matters related to banks would be primarily the responsibility of the Justice Department, while

¹⁰⁴ Steven A. Ramirez, *Depoliticizing Financial Regulation*, 41 WM & MARY L. REV. 503, 564 n.371 (2000).

¹⁰⁵ *Id.* at 33.

¹⁰⁶ *Id.*

securities matters related to banks would be primarily the responsibility of the SEC.¹⁰⁷

- In 1987, a Presidential commission headed by Nicholas Brady (the “Brady Commission”) recommended that the SEC and the CFTC should be merged into the Federal Reserve, which would serve as a single agency to regulate the securities and commodity futures markets.¹⁰⁸
- In 1994, Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, suggested in a statement before Congress that the OCC and the OTS ought to be merged to form a Federal Banking Commission to supervise all national banks and thrifts, but the Federal Reserve should continue to supervise state banks and bank holding companies.¹⁰⁹
- In 1994, the Treasury proposed consolidating the OCC and the OTS into a single agency, which would also have assumed some of the regulatory functions of the Federal Reserve.¹¹⁰
- In 1996, the GAO recommended that the OCC and the OTS be combined into a single agency, which also would have assumed the FDIC’s supervisory responsibilities in the new agency.¹¹¹

None of these efforts were ever adopted. Each of the foregoing proposals highlights the persistent problems with the existing regulatory structure that could be solved in part by consolidating agencies. These problems include poor communications and cooperation among agencies, unproductive and costly turf wars between agencies, inadequate or inconsistent regulations promulgated by agencies, and duplication of regulatory efforts by agencies.

III. CHALLENGES FACING THE CURRENT REGULATORY REGIME

The U.S. financial services regulatory structure is facing several major challenges which make the continued reliance on multiple regulators untenable. This section will examine these challenges and why the current system is unable to deal with them.

¹⁰⁷ *Id.* at 11-12, 91-92.

¹⁰⁸ REPORT OF THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS (1988) [hereinafter PRESIDENTIAL TASK FORCE REPORT].

¹⁰⁹ GAO FINANCIAL REGULATION REPORT, *supra* note 8, at 75-76.

¹¹⁰ *Id.*

¹¹¹ *Id.* at 77.

A. Need to Monitor Risks Across Firms and Sectors and to Address Such Risks Strategically.

1. EXISTING REGULATORS FAIL TO COMMUNICATE AND COOPERATE WITH ONE ANOTHER EFFECTIVELY.

The United States lacks a single forum in which all of the state and federal financial services regulators can meet to share information, assess risks that cross traditional regulatory sectors, and develop and coordinate regulations to address such risks. While forums exist for federal and state regulators operating within the same industry segment to coordinate activities, coordination and information sharing between regulators for different sectors currently occurs only on an ad hoc basis.¹¹² The GAO had the following dismal assessment of the existing efforts at cross-sector communication among the federal and state regulators:

In evaluating some of the means by which U.S. regulators communicate across sectors, we have found that these generally do not provide for the systematic sharing of information, making it more difficult for regulators to identify potential fraud and abuse, and for consumers to identify the relevant regulator. In addition, these means do not allow for a satisfactory assessment of risks that cross traditional regulatory and industry boundaries and therefore may inhibit the ability to detect and contain certain financial crises. . . .¹¹³

For more than a decade, the GAO has repeatedly identified the failure of federal and state financial regulators to communicate and coordinate across sectors, and even within the same sector, as a problem.¹¹⁴

¹¹² *Id.* at 97-98.

¹¹³ *Id.* at 109.

¹¹⁴ GAO, Long-Term Capital Management: Regulators Need to Focus Greater Attention on Systemic Risk (Oct. 29, 1999), in GAO/GGD-00-3; GAO, Financial Services Regulators: Better Information Sharing Could Reduce Fraud (March 6, 2001), in GAO-01-478T; GAO, State Insurance Regulation: Efforts to Streamline Key Licensing and Approval Processes Face Challenges (June 18, 2002), in GAO-02-842T; GAO, Potential Terrorist Attacks: Additional Actions Needed to Better Prepare Critical Financial Market Participants (Feb. 12, 2003), in GAO-03-251; GAO, Insurance Regulation: Common Standards and Improved Coordination Needed to Strengthen Market Regulation (Sept. 2003), in GAO-03-433; GAO, Bank Tying: Additional Steps Needed to Ensure Effective Enforcement of Tying Prohibitions (Oct. 2003), in GAO-04-4; and GAO, Better Information Sharing Among Financial Services Regulators Could Improve Protections for Consumers (June 29, 2004), in GAO-04-882R.

The existing inter-agency forums include the Federal Financial Institutions Examination Council (“FFIEC”), the President’s Working Group on Financial Markets (the “President’s Working Group”), the Financial and Banking Information Infrastructure Committee (“FBIIC”), the Financial Literacy and Education Commission, the North American Securities Administrators’ Association (“NASAA”), the Conference of State Bank Supervisors (“CSBS”), and National Association of Insurance Commissioners (“NAIC”).¹¹⁵ Of these, the FFIEC, the President’s Working Group, and the FBIIC come the closest to creating an interagency forum for strategically addressing the issues facing the financial services industry. Unfortunately, the scope of these groups’ authority is too limited to meet the needs of the financial services industry.

The FFIEC was created on March 10, 1979, pursuant to Title X of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (the “FFIEC Act”).¹¹⁶ The FFIEC is comprised of the Federal Reserve, the FDIC, the NCUA, the OCC, and the OTS.¹¹⁷ The mission of the FFIEC is to prescribe uniform principles and standards for the examination of financial institutions and, following the enactment of the GLBA, to have an increased coordinating role.¹¹⁸ The President’s Working Group was created by executive order in 1988 to analyze the 1987 stock market crash and was reactivated in 1994.¹¹⁹ It is comprised of the heads of the Federal Reserve, the SEC, the CFTC, and the Treasury, and has dealt with a wide range of issues, generally related to more recent crises.¹²⁰

The FBIIC was created by a Presidential executive order following the September 11, 2001 attacks and was tasked with ensuring the preparedness and stability of the financial sector in the event of future threats.¹²¹ The FBIIC is comprised of representatives from the Federal Reserve, FDIC, OCC, OTS, SEC, CFTC, NCUA, NAIC, CSBS, OFHEO, the Federal

¹¹⁵ GAO FINANCIAL REGULATION REPORT, *supra* note 8, at 97-108. NAIC, NASAA and CSBS are the associations for the state insurance, securities, and banking regulators, respectively. The Financial Literacy and Education Commission was created by Congress to coordinate efforts to educate the public on financial matters and is composed of 20 federal agencies, including all of the federal financial regulators. *Id.* at 108.

¹¹⁶ OFFICE OF INSPECTOR GENERAL, THE DEPARTMENT OF THE TREASURY, JOINT EVALUATION OF THE FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL 3 (2002) [hereinafter OIG FFIEC REPORT].

¹¹⁷ *Id.* at 3-4.

¹¹⁸ *Id.* at 3.

¹¹⁹ GAO FINANCIAL REGULATION REPORT, *supra* note 8, at 107.

¹²⁰ *Id.* The President’s Working Group addressed the 1997 market decline, year 2000 preparedness issues, and the growth of the over-the-counter derivatives market. *Id.*

¹²¹ *Id.*

Housing Finance Board, the Office of Homeland Security, and the Office of Cyberspace Security.¹²² None of these groups currently has the authority, jurisdiction or resources to ensure the systematic sharing of information between regulators in order to coordinate their activities and to assess the systemic risks to the financial industry as a whole.¹²³

Inter-agency rivalries have also deterred efforts to expand the scope and composition of these groups in order to provide a strategic assessment of the financial industry's risk. In March 2002, the Inspectors General of the Treasury, the FDIC, and the Federal Reserve completed a joint evaluation of the FFIEC.¹²⁴ One of the items that they investigated was whether the membership of the FFIEC ought to be broadened to include other regulators, such as the SEC and the CFTC, in order to better assess the risks confronting the financial services industry. While the Inspectors General interviewed staff members of the agencies that already composed the FFIEC, they did not interview anyone from the SEC or the CFTC. In addition, the Inspectors General did not obtain any information from the SEC or CFTC regarding major risks or emerging issues facing the banking industry, despite the fact that banks are increasingly competing against other financial entities.¹²⁵ It is not surprising that the Inspectors General found that the officials of the Federal Reserve, FDIC, NCUA, OCC and OTS were not in favor of expanding FFIEC membership to include agencies that regulate the insurance and securities sectors.¹²⁶ The existing members of the FFIEC also opposed creating a separate coordinating entity under the GLBA in order to handle cross-sectoral issues because they felt that the periodic meetings called by the Federal Reserve or other ad hoc arrangements adequately dealt with cross-sectoral issues.¹²⁷ This opposition existed, even though "some officials indicated that the relationship between the banking agencies and the SEC needed to be improved through better dialogue."¹²⁸

The report went on to state that the banking agencies and the SEC were in the process of negotiating a memorandum of understanding ("MOU") covering the sharing of critical information on a case-by-case basis.¹²⁹ It also commented that coordination with state banking regulations needs to be improved.¹³⁰ Currently, five state banking commissioners comprise the State

¹²² *Id.*

¹²³ *Id.* at 107-08.

¹²⁴ OIG FFIEC REPORT, *supra* note 116, at 3.

¹²⁵ *Id.* at 22.

¹²⁶ *Id.* at 6.

¹²⁷ *Id.*

¹²⁸ *Id.*

¹²⁹ *Id.*

¹³⁰ OIG FFIEC REPORT, *supra* note 116, at 9.

Liaison Committee to the FFIEC, but these commissioners do not have voting rights on the FFIEC.¹³¹

Out of the three existing inter-agency forums, only the FBIIC contains representatives from the insurance regulators. When questioned by the Inspectors General about expanding the FFIEC to include insurance regulators, the existing members of the FFIEC pointed to the bilateral information sharing agreements between the banking agencies and state insurance commissioners as effective mechanisms for sharing relevant regulatory information.¹³² Not all states, however, have signed such agreements with all of the federal banking agencies. By the end of 2001, 45 states had agreements with the OTS, 23 states had agreements with the OCC, 31 states had agreements with the FDIC, and only eight states had agreements with the Federal Reserve.¹³³ Only 30 percent of the state banking commissioners had entered into information sharing agreements with state insurance commissioners by the end of 2001, although an unspecified number of state banking commissioners reportedly had informal information sharing arrangements with state insurance commissioners.¹³⁴ While such agreements established mechanisms for sharing information between the agencies who are parties to the agreements, they do not establish a mechanism for ensuring that the information reaches all of the agencies that may need it, nor do they establish a mechanism for jointly evaluating the issues raised by the information.

The FFIEC also highlights the inherent problems with these inter-agency forums as means to resolve the communication and coordination problems that currently exist among the regulators. First, the FFIEC has no legal authority to force agency members to adopt a particular proposal, but serves only as a coordinating and policy-making entity.¹³⁵ Because the FFIEC lacks rulemaking authority, any projects resulting in rulemaking must be issued jointly by the relevant agencies.¹³⁶ In addition, the FFIEC's effectiveness seems to be contingent on who the members are at a given time.¹³⁷

¹³¹ *Id.* at 8-9.

¹³² *Id.* at 18.

¹³³ *Id.*

¹³⁴ *Id.*

¹³⁵ 12 U.S.C.S. § 3305 (2004).

¹³⁶ OIG FFIEC REPORT, *supra* note 116, at 7.

¹³⁷ *Id.* at 7. The Inspectors General report noted:

A number of the officials noted that the Council's success depended in large part on the individual principal's interaction and level of commitment to the FFIEC. One senior agency official indicated that while the FFIEC exists in law, in practice the FFIEC exists at the consent of the Council and task force members. One principal stated that personal relationships are

Second, not all agencies are involved in the FFIEC, rendering it ineffective for handling issues that must be dealt with quickly or involve agencies that are not members.¹³⁸

2. CURRENT SYSTEM CONTAINS INCONSISTENT REGULATIONS

Inconsistent regulations exist within the current regulatory regime because functional regulation was imperfectly enacted in the GLBA. For example, some bank securities activities continue to be subject to the oversight of bank regulators rather than the SEC. These products and activities include commercial paper and exempted securities, private placements, asset-backed securities, derivatives, third-party networking arrangements, trust activities, employee and shareholder benefit plans, sweep accounts, affiliate transactions, and safekeeping and custody services.¹³⁹ In addition, national banks can continue to engage in underwriting any of the insurance products that had been authorized by the Office of the Comptroller of the Currency (“OCC”) as of January 1, 1999.¹⁴⁰

The existing regulatory regime also does not work well for products or services that do not clearly fall into one of the banking, securities or insurance categories. Section 205 of the GLBA defines “new hybrid product” as one that was not previously defined as a security before the enactment of the GLBA and is not defined as an identified banking product within the GLBA.¹⁴¹ This definition does not mention the possibility of the product

important at all levels of the FFIEC and that without good relationships there is no basis for completing inter-agency projects.

Id.

¹³⁸ *Id.* at 10. Even FBIC which has the widest membership, does not have representatives from the financial regulators in all 50 states and the associations of state regulators that are members (NAIC, CSBS, and NASAA) do not have the authority to bind their members.

¹³⁹ 15 U.S.C.S. § 78c(a)(4)(B) (2004). The top ten banks and thrifts based on income from mutual fund and annuity sales earned over \$3.8 billion in income from such sales in 2001. THE FINANCIAL SERVICES FACT BOOK, *supra* note 3, at 75 (2003). The top ten banks and thrifts in terms of income from mutual fund and annuity sales were Bank of America NA, Mellon Bank NA, First Union NA, PNC Bank NA, JPMorgan Chase Bank, Wells Fargo Bank NA, Bank of New York, Washington Mutual Bank, Fleet Bank NA, and Citibank NA.

¹⁴⁰ GLBA § 302.

¹⁴¹ GLBA § 205 (codified at 15 U.S.C.S. § 78o(i)(5)(D) (2004)). Section 206 of the GLBA defines “identified banking product” as a deposit account, savings account, certificate of deposit, or other deposit instrument issued by a bank, a banker’s acceptance, a letter of credit or loan made by a bank, a debit account at a bank arising from a credit card or similar arrangement, a participation in a loan which the bank or an affiliate of the bank (other than a broker or dealer) funds, participates in, or owns that is sold to qualified investors or sophisticated investors, or any swap agreement, except for any equity swap sold to a person other than a qualified investor.

being an insurance product, nor does Section 205 require the SEC to consult with the state insurance regulators before issuing rules governing hybrid products that may be combinations of insurance and securities products.¹⁴² Hybrid securities and insurance products do exist. Variable annuities, which are regulated by both the SEC and the state insurance commissions, are one example of such hybrid securities and insurance products.

Section 104 of the GLBA reaffirmed that the states would retain control over the regulation of insurance products and services.¹⁴³ Nevertheless, Section 104(c) prohibits states from preventing or restricting a depository institution or an affiliate of such institution from being affiliated with any person except in certain limited circumstances related to insurers.¹⁴⁴ The GLBA permits states to collect, review and take actions (including approval or disapproval) on applications concerning the proposed acquisition of, or change or continuation of control of, an insurer domiciled in the state, or to require a person seeking to acquire control of an insurer to maintain or restore the insurer's capital requirements under the state's capital regulations, or to restrict the change in control in the ownership of stock in the insurer, or a company formed for the purpose of controlling the insurer, after the insurer has converted from a mutual to a stock form so long as such restrictions do not discriminate against depository institutions or their affiliates.¹⁴⁵

These inconsistent regulations mean that companies competing with one another face an uneven playing field because they are governed by different regulators and different rules.¹⁴⁶ Thus, these regulations decrease competition and distort the markets for financial products.

3. CURRENT SYSTEM CONTAINS DUPLICATIVE REGULATIONS

Numerous studies have identified the problem of overlapping regulatory authorities producing inconsistent regulations.¹⁴⁷ For example, the GAO

¹⁴² GLBA § 205 (codified at 15 U.S.C.S. § 78o(i)(5)(D) (2004)).

¹⁴³ GLBA § 104.

¹⁴⁴ GLBA § 104(c).

¹⁴⁵ GLBA § 104(c)(2). In the event of a dispute between federal regulators and state insurance regulators regarding insurance, the GLBA provided for a dispute resolution mechanism under which either the federal or the state regulator may seek expedited review from the U.S. Court of Appeals for the circuit in which the state is located or from the U.S. Court of Appeals for the D.C. Circuit. 15 U.S.C.S. § 6714 (2004).

¹⁴⁶ David L. Ratner, *Response the SEC at Sixty: A Reply to Professor Macey*, 16 CARDOZO L. REV. 1765, 1773 (1995) ("A system in which some of the firms competing for a certain market are regulated in one way and others in a different way, leads to competitive unfairness and customer confusion.")

¹⁴⁷ For example, the GAO Financial Regulation Report, the Task Group Report, and the Presidential Task Force Report all cited this as a problem.

Financial Regulation Report, the Task Group Report, and the Presidential Task Force Report all cited this as a problem in the areas of banking and securities. Sheila Bair of the University of Massachusetts, Isenberg School of Management completed a study (the “Bair Report”) on the consumer ramifications of creating an optional federal charter for life insurers in 2004.¹⁴⁸ The Bair Report concluded that the duplicative nature of state insurance regulations resulted in: (1) multiple state reviews of product filings that are cumbersome and inefficient; and (2) significant delays in multi-state company licensing that have inhibited the ability of smaller companies to expand operations and have benefited larger companies with pre-established multi-state infrastructures.¹⁴⁹

The federal and state banking and insurance regulators have over the years attempted to eliminate some duplicative practices by jointly issuing regulations and by adopting common forms for certain activities. An example of such cooperation may be found in the banking area, in which the OCC, OTS and the FDIC have adopted a uniform application form for a charter and federal deposit insurance in 2002.¹⁵⁰ The form allows an entity to fill out one application when seeking a charter to become a national bank or thrift and to apply for federal deposit insurance. The agencies worked with the Conference of State Bank Supervisors in the hope that most states would also adopt the form for entities applying for state charters.¹⁵¹

The GLBA also required states to establish uniform or reciprocal requirements for licensing of insurance agents.¹⁵² The GLBA mandated that the NAIC had to determine whether a majority of states had to meet this requirement within three years after the enactment of the GLBA.¹⁵³ If the NAIC was unable to do so, then the National Association of Registered Agents and Brokers would be established as a non-profit corporation to act as a mechanism through which “uniform licensing, appointment, continuing education, and other insurance producer sales qualification requirements and conditions” could be adopted.¹⁵⁴

Perhaps not surprisingly, when given a choice between reciprocity and uniformity, the states chose reciprocity.¹⁵⁵ Reciprocity only required that

¹⁴⁸ BAIR REPORT, *supra* note 23, at i-ii. The study focused solely on life insurance and not the other forms of insurance, although it did concede that other insurers, particularly property and casualty insurers, faced many of the same regulatory inefficiencies.

¹⁴⁹ *Id.*

¹⁵⁰ *Regulators Issue Common Form*, 21 BANKING & FIN. SERVICES POLICY RPT. 7 (Aug. 2002).

¹⁵¹ *Id.*

¹⁵² 15 U.S.C.S. § 6751 (2004).

¹⁵³ *Id.*

¹⁵⁴ 15 U.S.C.S. § 6752-53 (2004).

¹⁵⁵ Richard J. Hillman, Director, Financial Markets and Community Investment, General Accounting Office, Testimony Before the Subcommittee on Capital Markets, Insurance and Government

states accept the licensing decisions of other states, even though their requirements might be different, while uniformity would have required the same set of requirements to be applied by the states. As of December 29, 2004, the NAIC had certified 41 states as meeting the reciprocity requirements under the GLBA.¹⁵⁶ Nevertheless, major states, like California, New York and Florida, still have not complied with the reciprocity requirements.¹⁵⁷ The major stumbling blocks to nationwide reciprocity are the fingerprinting and surplus lines bond requirements for nonresident producers, which are considered important consumer protection issues in the states that require them, particularly California and Florida.¹⁵⁸ Both industry representatives and the NAIC have admitted that until states with large insurance markets reciprocate in the licensing process, the states' reciprocity initiative would not be completely successful.¹⁵⁹

In reviewing the NAIC's progress in complying with the GLBA's requirements, the GAO commented, "If the objective of NAIC's agenda of regulatory reform and modernization is simply to have all states agree, then *what has occurred thus far may be considered a failure.*"¹⁶⁰ The GAO also concluded that "state regulators and NAIC may not be able to achieve uniformity through common consent" and federal oversight and intervention might be required to achieve "positive change and continuing improvement in state regulation of insurance."¹⁶¹ The state insurance regulators through the NAIC have unsuccessfully attempted several times to centralize the filing and approval process for some types of life and health insurance products¹⁶² and to facilitate the licensing process for companies that want to provide insurance on a multi-state basis.¹⁶³

Sponsored Enterprises, Committee on Financial Services, House of Representatives, State Insurance Regulation: Efforts to Streamline Key Licensing and Approval Processes Face Challenges 2 (June 18, 2002).

¹⁵⁶ Responding to the NARAB Requirement, <http://www.naic.org/GLBA/narab.htm> (last visited Dec. 29, 2004).

¹⁵⁷ *Id.*

¹⁵⁸ *Id.*

¹⁵⁹ Hillman, *supra* note 155, at 2. In addition, the GAO noted that some state licensing requirements that were waived in order to meet the reciprocity requirements under the GLBA have been recharacterized as postlicensing requirements, which undermines the GLBA's intended benefits of streamlining insurance regulations. *Id.* at 7.

¹⁶⁰ *Id.* at 16 (emphasis added).

¹⁶¹ *Id.* at 17.

¹⁶² *Id.* at 2; NAIC, INTERSTATE INSURANCE PRODUCT REGULATION COMPACT, Art. III (2003), available at <http://www.naic.org/GLBA/narab.htm> (last visited Dec. 29, 2004).

¹⁶³ NAIC attempted to implement the National Treatment and Coordination initiative, which sought to facilitate the licensing process for companies that want to provide insurance on a multi-state basis. Hillman, *supra* note 155, at 3. NAIC abandoned its initial efforts to provide a more centralized insurer licensing and oversight process. NAIC's draft 2004 Work Plan of the National Treatment and

These efforts by federal and state regulators to reduce duplicative regulations have only had a marginal impact. The unsuccessful efforts at achieving uniformity and information sharing both at the federal and state levels suggest that the existing regulatory agencies probably will never cooperate to the degree necessary to create a uniform national market with the same laws, rules and standards for competing financial products and firms.

4. THE CURRENT REGIME CONTAINS REGULATORY GAPS.

Even though Congress, in the GLBA, assigned the primary responsibility for regulating some hybrid products to certain agencies, regulatory gaps still exist. The narrowly defined sectoral responsibilities of the existing agencies results in situations similar to those that occur in baseball when two outfielders are each pursuing a fly ball. Each assumes that the other will make the play, and so neither attempts to catch the ball.¹⁶⁴ The results in the financial services industry can be equally disastrous for consumers and the economy when the existing agencies drop the ball concerning the regulation of innovative products and firms.

The rescue of Long-Term Capital Management (“LTCM”) illustrates one of these gaps in the existing regulatory structure. LTCM was founded in 1994 by John Meriwether, a former Salomon Brothers trader, and a small group of associates including Nobel Prize winning economists Robert Merton and Myron Scholes.¹⁶⁵ LTCM initially specialized in high-volume arbitrage trades in bond and bond-derivatives markets, but eventually began

Coordination (EX) Working Group under this initiative calls for standardizing the filing and baseline review procedures for insurance company licensing. NATIONAL TREATMENT & COORDINATION (EX) WORKING GROUP, NAIC, DRAFT 2004 WORK PLAN (2004). The draft NAIC 2004 Work Plan of the National Treatment and Coordination (EX) Working Group notes that all 50 states and the District of Columbia have adopted NAIC’s Uniform Certificate of Authority Application, but that a number of state specific application filing requirements still exist. NATIONAL TREATMENT & COORDINATION (EX) WORKING GROUP, NAIC, DRAFT 2004 WORK PLAN (2004).

¹⁶⁴ For example, Section 43 of the FDI Act designates that the FTC should enforce the prohibitions against a depository institution claiming to have federal deposit insurance when it does not. GEN. ACCOUNTING OFFICE, GAO HIGHLIGHTS: FTC BEST AMONG CANDIDATES TO ENFORCE CONSUMER PROTECTION PROVISIONS (2003), at <http://gao.gov/cgi-bin/getrpt?GAO-03-971>. Neither the FTC, the FDIC, nor the NCUA, however, want to be responsible for enforcing this section. *Id.* The FTC had gotten Congress enact as part of its appropriations bill, a passage that prohibits the FTC from enforcing Section 43. *Id.* Neither the FDIC nor NCUA want to be responsible for enforcing the provision against entities that they do not insure. *FTC Best Among Candidates to Enforce Consumer Protection Provisions*, GAO Highlights (2003).

¹⁶⁵ KEVIN DOWD, CATO INSTITUTE BRIEFING PAPERS NO. 52, TOO BIG TO FAIL? LONG TERM CAPITAL MANAGEMENT AND THE FEDERAL RESERVE 3 (CATO INSTITUTE) (1999) [hereinafter DOWD, TOO BIG TO FAIL].

to engage in other markets and in speculation.¹⁶⁶ By the end of 1997, LTCM had developed an impressive track record with an average annual rate of return of approximately 40 percent.¹⁶⁷ LTCM's assets had grown to \$120 billion and its capital had grown to about \$7.3 billion by 1997, making it one of the largest hedge funds in the United States.¹⁶⁸

In order to achieve the rate of return for which it was aiming, LTCM decided that it needed to return \$2.7 billion of capital to the shareholders.¹⁶⁹ LTCM took a gamble that by increasing the risk of the fund, it would enhance the returns for its shareholders.¹⁷⁰ Unfortunately, the markets deteriorated in the summer of 1998, leading to catastrophic losses for LTCM in July of 1998.¹⁷¹ In August of 1998, the Russian government devalued the ruble and declared a moratorium on future debt repayments.¹⁷² Unfortunately for LTCM, this resulted in the spreads between the prices of Western government and emerging market bonds widening.¹⁷³ LTCM had taken speculative positions based on their assumptions that such spreads would narrow.¹⁷⁴ By September 19, 1998, the fund's capital had fallen to \$600 million and its assets were down to \$80 billion.¹⁷⁵ LTCM was not expected to survive without outside assistance.¹⁷⁶

On September 20th, 1998, the New York Federal Reserve and the U.S. Treasury met with LTCM partners to ascertain whether the U.S. government needed to intervene.¹⁷⁷ The LTCM partners were able to convince the government delegation that the situation was much worse than market participants thought.¹⁷⁸ Wall Street firms, particularly those with investments in LTCM, were already concerned that the failure of LTCM would have a significant negative impact on other financial institutions.¹⁷⁹

Based on that meeting, the Federal Reserve gathered a group of 14 of LTCM's creditors to discuss a rescue package for LTCM. This group was originally supposed to meet on September 23rd, 1998 but delayed their meeting to see how LTCM would respond to an offer made by a group

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Id.

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Id.

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Id.

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Id.

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Id.

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DOWD, TOO BIG TO FAIL, *supra* note 165, at 3.

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Id.

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Id.

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Id.

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Id. at 4.

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DOWD, TOO BIG TO FAIL, *supra* note 165, at 4.

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Id.

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Id.

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Id.

comprised of Berkshire Hathaway, Goldman Sachs and American International Group.¹⁸⁰ That group had offered to buy out all of LTCM's shareholders for \$250 million and to put \$3.75 billion into the fund as new capital and to replace the fund's managers with new ones.¹⁸¹

LTCM rejected the offer made by Berkshire Hathaway, Goldman Sachs and American International Group. Some speculate that LTCM rejected the offer because its managers expected to get a better offer from the Federal Reserve consortium.¹⁸² The package ultimately offered by the creditor consortium and accepted by LTCM allowed existing shareholders to retain a 10 percent holding, valued at \$400 million, while the consortium invested an additional \$3.65 billion in equity capital in LTCM in exchange for 90 percent of the firm's equity.¹⁸³ In addition, the LTCM managers were allowed to retain their jobs.¹⁸⁴ By the end of 1998, LTCM had once again resumed making profits.¹⁸⁵

The Federal Reserve was acting without a mandate when it intervened in the LTCM crisis. It was not responsible for regulating hedge funds, however LTCM fell outside of the regulatory authority of any other government agency. It was not regulated by the SEC because at the time of its crisis, U.S. hedge funds with fewer than 100 shareholders were exempt from regulation under the Securities Act of 1933,¹⁸⁶ the Securities Exchange Act of 1934,¹⁸⁷ and the Investment Company Act of 1940.¹⁸⁸ In addition, such hedge funds were not regulated by any other regulatory agency.¹⁸⁹ In fact, the majority of U.S. hedge funds had restricted the number of their shareholders to fewer than 100 to avoid being regulated.¹⁹⁰ Overseas hedge funds were also subject to little or no regulation and as a result, the hedge-

¹⁸⁰ *Id.*

¹⁸¹ *Id.*

¹⁸² DOWD, TOO BIG TO FAIL, *supra* note 165, at 5. LTCM has never provided their rationale for rejecting the offer. Prof. Dowd believes that LTCM rejected the offer because LTCM felt it had leverage to bargain with the Federal Reserve, which was desperate to prevent LTCM's failure and would want to give the LTCM managers a reason to cooperate with it. *Id.*

¹⁸³ *Id.*

¹⁸⁴ *Id.*

¹⁸⁵ *Id.*

¹⁸⁶ Securities Act of 1933, ch. 38, § 1, 48 Stat. 74 (1933) (current version at 15 U.S.C.S. § 78a et seq.).

¹⁸⁷ Securities Exchange Act of 1934, ch. 404, § 1, 48 Stat. 881 (current version at 15 U.S.C.S. § 78a et seq.).

¹⁸⁸ Investment Advisers Act of 1940, ch. 686, § 220, 54 Stat. 857 (current version at 15 U.S.C.S. § 806-1 et seq.).

¹⁸⁹ DOWD, TOO BIG TO FAIL, *supra* note 165, at 2-3.

¹⁹⁰ *Id.* at 3.

fund industry was essentially unregulated.¹⁹¹ Nevertheless, like LTCM, these firms can have profoundly negative impacts on the financial markets if they become insolvent.¹⁹² While many other regulatory gaps exist, no forum or mechanism has been established to assess them or to address the problems that they pose.

B. Need to Regulate Financial Conglomerates More Effectively.

1. CURRENT SYSTEM HAS FAILED TO DEAL EFFECTIVELY WITH THE RANGE OF CONFLICTS OF INTEREST CREATED BY FINANCIAL CONGLOMERATES.

Financial conglomerates raise conflict of interest concerns that have become more problematic following the enactment of the GLBA because the financial regulatory structure was not modified to adequately address them. In fact, by removing many of the restrictions regarding affiliations between financial institutions, the GLBA has allowed a wide range of conflicts of interest to develop and fester. For example, financial conglomerates are increasingly accused of conditioning commercial lending on commitments by the borrowers to also use the bank's investment banking services.¹⁹³ This practice is problematic for several reasons.

First, conditional lending distorts the market for financial services by forcing companies to purchase services at inflated prices in order to obtain services that they need. Congress prohibited bank loans conditioned on the receipt of other business by the same bank more than 30 years ago in order to prevent this type of distortion. Nevertheless, financial conglomerates can circumvent this law by making the conditioned loans through a holding company or a securities firm. Businesses have commented that banks are not subtle about making the linkage between loans and other business. David Hauser, Vice President and Treasurer of Duke Energy Corp., commented to the Wall Street Journal that "there is clearly an expectation on their part of other business" when banks provide loans.¹⁹⁴

¹⁹¹ *Id.*

¹⁹² Over five years after LTCM, concerns about the impact of hedge funds finally prompted the SEC to adopt a rule that would require certain advisers to hedge funds to register with the SEC. SEC, Final Rule: Registration Under Advisers Act of Certain Hedge Fund Advisers, SEC Release No. IA-2333.

¹⁹³ Jathon Sapsford and Paul Beckett, *Loss Leader: Linking of Loans to Other Business Has Perils for Banks*, WALL ST. J., Sept. 19, 2002, at A1; Christopher O'Leary, *A Closer Look at Derivatives*, INVESTMENT DEALERS' DIGEST, Jan. 6, 2003, available at <http://www.iddmagazine.com/idd/NYTSSstories/1031551057358.htm> (last visited January 26, 2006); Michelle Celarier, *The God That Failed—We Went Too Far With This—Felix Rohatyn*, INVESTMENT DEALERS DIGEST, Jan. 6, 2003.

¹⁹⁴ Sapsford and Beckett, *supra* note 193, at A1 & A11.

The Association for Financial Professionals published the results of a credit access survey in March 2003,¹⁹⁵ which examined how often corporate credit was linked to the awarding of other financial services. The survey found that 56 percent of the respondents from large companies (companies with annual revenues of \$1 billion or more) reported that their commercial bank credit providers had either denied credit or adversely changed the credit terms after the company had not awarded them other financial business.¹⁹⁶ This problem was most acute when the company failed to award the commercial bank investment banking business.¹⁹⁷ Only 17 percent of the respondents from large companies reported that their company did not suffer any negative impact on its credit relationship with its commercial bank when it did not award the bank other financial business.¹⁹⁸ This survey also found that 33 percent of the respondents from all of the companies surveyed, and 53 percent of respondents from the large companies surveyed, reported that a commercial bank implied that they were denied credit or had the credit terms changed because those companies did not award the commercial bank other business.¹⁹⁹ Indeed, 29 percent of the large companies and 17 percent of all of the companies surveyed reported that the commercial bank explicitly told them that they had denied credit or had changed the credit terms because the companies had failed to award them other business.²⁰⁰

The pressure from banks is growing. Fifty-six percent of large company respondents and about 20 percent of all company respondents stated that the pressure to award additional business had grown over the prior year.²⁰¹ About 90 percent of the respondents from large companies reported that they had been pressured by their banks to award the banks other financial business in the prior year.²⁰²

The result of banks' attempts to link credit access to other financial services is that about 85 percent of the large companies surveyed and 76 percent of all companies surveyed admitted that they now give priority to credit providers when awarding other financial business in order to protect their access to credit.²⁰³ No respondent to the survey indicated that they had

¹⁹⁵ Association for Financial Professionals, *Credit Access Survey: Linking Corporate Credit to the Awarding of Other Financial Services* (March 2003).

¹⁹⁶ *Id.* at 5.

¹⁹⁷ *Id.*

¹⁹⁸ *Id.* at 2.

¹⁹⁹ *Id.* at 7.

²⁰⁰ *Id.* at 6.

²⁰¹ Association for Financial Professionals, *Credit Access Survey: Linking Corporate Credit to the Awarding of Other Financial Services* 9 (March 2003).

²⁰² *Id.*

²⁰³ *Id.* at 11.

reported any of these activities to a regulator, which was partly due to the fact that some respondents thought such tying arrangements were legal while others worried about the negative repercussions of such a report.²⁰⁴ Another reason tying has not been reported to regulators is because it is hard to prove.²⁰⁵ Ray Soifer, a former bank analyst at Brown Brothers Harriman and a former executive at Bankers Trust, which was acquired by Deutsche Bank, told the *Investment Dealers' Digest* that “[t]here’s always documentation in the file that these laws were not violated.”²⁰⁶ For example, he said that at Bankers Trust, the loan documents always had a clause stating that “the borrower acknowledges that no other service was involved.”²⁰⁷

Another problem with tying is that it encourages banks to make barely profitable or unprofitable loans in order to obtain future, profitable investment banking business. Tying thus raises prudential issues in addition to conduct of business issues; if the corporation is unable to go forward with the anticipated investment banking transactions then the banks may be saddled with bad debts that they will have to write-down or write-off. Banks have acknowledged that traditional bank lending is not very profitable and that other business with the company effectively subsidizes the bank loans.²⁰⁸ The commissions on loans can equal as little as 0.1 percent of the loan’s value while the fees for managing a stock deal may equal as much as 7 percent of the offering’s value.²⁰⁹

Prominent firms like Bank of America, J.P. Morgan Chase & Co. and Citigroup have compromised their lending standards in order to enter into such arrangements.²¹⁰ In August 2002, Moody’s Investors Service placed the long term debt of J.P. Morgan Chase & Co. on a credit watch for a possible downgrade, partly due to the fact that it considered J.P. Morgan’s strategy of using commercial banking relationships to boost its investment banking business to be a “mixed success.”²¹¹ J.P. Morgan Chase & Co. incurred \$1.4 billion in costs due to loans that it made to companies in the telecommunications and cable sectors in anticipation of return investment banking business.²¹²

²⁰⁴ *Id.* at 3.

²⁰⁵ Celarier, *supra* note 193.

²⁰⁶ *Id.*

²⁰⁷ *Id.*

²⁰⁸ Sapsford and Beckett, *supra* note 193, at A1; Jake Keaveny, *IPO View—Wall Street Banks Lend More to Win Business*, REUTERS (Feb. 3, 2003); Celarier, *supra* note 193.

²⁰⁹ Keaveny, *supra* note 208.

²¹⁰ Sapsford and Beckett, *supra* note 193, at A11; O’Leary, *supra* note 193.

²¹¹ Sapsford and Beckett, *supra* note 193, at A11.

²¹² *Id.*

Citigroup and several other banks lent \$4.3 billion to WorldCom based in part on the expectation that they would have a role in WorldCom's planned \$11.8 billion bond issuance in 2001.²¹³ The bond issuance never occurred and Citigroup was left with more than \$300 million in exposure to WorldCom, which filed for bankruptcy following revelations of massive fraud by the company.²¹⁴ In 2002, Bank of America joined J.P. Morgan in arranging a \$1.6 billion loan for a U.S. affiliate of Vivendi Universal SA allegedly based in part on a promise by Vivendi that it would give each of the banks a role in a future bond sale.²¹⁵ Shortly after making the loan, Vivendi's stock and bond prices began to decline and the ratings for Vivendi's debt were downgraded, preventing the bond sale from going forward.²¹⁶ Vivendi's financial troubles also raised questions about whether it would be able to repay the \$1.6 billion loan.²¹⁷

Sometimes it is the companies, not the banks, who require that loans be linked to the purchase of other services. When companies require such linkage, it is referred to as "pay to play."²¹⁸ The chief executives of Merrill Lynch and J.P. Morgan Chase have stated that banks that want to win debt and equity deals also need to also be able to supply loans.²¹⁹ Vodafone Plc and Ford Motor Co. are two examples of companies who required banks that wanted to be included in advisory and underwriting business to provide them with lines of credit.²²⁰ Clients were able to wield this power in the hypercompetitive environment that the deregulation of the financial services sector spawned.²²¹ Ralph Della Ratta, head of investment banking at the Cleveland-based McDonald Investments, explained that "[t]he power really ceded to the corporations, and the CEOs and the CFOs had incredible power over Wall Street. . . . The power was in the hands of the Kenneth Lays of this world. It was absolute power, and we know how it corrupts."²²²

The problem of tying also illustrates the dangers of having narrowly focused financial regulators. In the case of tying, the bank regulators are viewed as being more sympathetic to the banks' contention that they are not engaged in illegal tying than the securities regulators. Federal Reserve Chairman Alan Greenspan and Comptroller of the Currency John D. Hawke

²¹³ *Id.*

²¹⁴ *Id.*

²¹⁵ *Id.*

²¹⁶ Sapsford and Beckett, *supra* note 193, at A11.

²¹⁷ *Id.*

²¹⁸ Celarier, *supra* note 193.

²¹⁹ Keaveny, *supra*, note 208.

²²⁰ Celarier, *supra* note 193.

²²¹ *Id.*

²²² *Id.*

Jr. both stated in a letter to Representative John D. Dingell, Democrat of Michigan, in August 2002 that they were not aware that commercial banks were engaged in tying loans to other financial services, but they promised to review the matter.²²³ When the GAO investigated tying in 2003, it commented that the Federal Reserve and the OCC in their investigations had failed to analyze a broad range of transactions or generally to solicit information from corporate borrowers.²²⁴ The GAO noted that the loan documentation that banks maintained did not generally provide the type of evidence needed to prove a case of illegal tying and that it was necessary for the Federal Reserve and the OCC to enhance the information that they received from corporate borrowers.²²⁵

SEC Chairman William H. Donaldson also promised to investigate the matter during his confirmation hearings; the NASD was conducting an investigation into tying as well.²²⁶ In February 2003, several commercial banks, including Citigroup, JP Morgan Chase, the Bank of America, and Deutsche Bank, reportedly attempted to prevent NASD's investigation into the tying allegations on the grounds that lending operations were outside of the NASD's jurisdiction.²²⁷ The NASD, as a securities regulator, was seen as being less likely to find that the commercial banks were complying with the anti-tying laws than traditional bank regulators like the Federal Reserve and the OCC.²²⁸

2. CURRENT SYSTEM HAS FAILED TO ADEQUATELY ADDRESS THE "TOO-BIG-TO-FAIL" PROBLEM POSED BY FINANCIAL CONGLOMERATES.

The trend in the financial services industry is towards ever expanding financial conglomerates that combine not only traditional commercial banking, but investment banking and insurance as well. This trend has been aided by the passage of the GLBA and the adoption of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994,²²⁹ which eliminated the barriers to interstate banking. Such mergers allow bank holding

²²³ Riva D. Atlas, *Corporations in Survey Say Banks Tie Loans to Other Business*, N.Y. TIMES, March 19, 2003, at C4.

²²⁴ GOV'T. ACCT. OFF., GAO-04-4, 5, *BANK TYING: ADDITIONAL STEPS NEEDED TO ENSURE EFFECTIVE ENFORCEMENT OF TYING PROHIBITIONS* (2003).

²²⁵ *Id.*

²²⁶ *Id.*; Adrian Michaels & Gary Silverman, *Leading US Banks Unite to Fight 'Tying' Probe*, FIN. TIMES, Feb. 10, 2003, at 30.

²²⁷ *Id.*

²²⁸ *Id.*

²²⁹ Pub. L. No. 103-328, 108 Stat. 2338 (codified at 12 U.S.C.S. § 1831a) (1999).

companies to be more diversified both geographically and across economic sectors, leaving them less vulnerable to regional or sectoral slumps.²³⁰

The immense size of these new financial conglomerates means that if a single one of these firms failed, it could bankrupt the taxpayer-backed deposit insurance fund.²³¹ As Arthur J. Rolnick, the research director at the Federal Reserve Bank of Minneapolis in 1998, noted, “[w]ith the safety net starting to extend beyond banking, the potential taxpayer exposure has grown.”²³²

The capital structure of such mega-banks could be undermined by excessive speculation by the traders in its investment-banking subsidiary or by mismanagement of underwriting by its insurance subsidiary.²³³ Federal regulators may feel compelled to bail out such financial conglomerates out of concern that allowing such a bank to fail would have a cascade effect on the financial system, causing other financial institutions to also collapse.²³⁴ The sheer size of such institutions may breed a sense within the organizations that they are “too big to fail.”²³⁵

One of the motivations posited for these mergers is that banks are actively seeking to become too big to fail. Such a strategy would allow all uninsured liabilities to effectively gain insurance coverage because the regulatory authorities, particularly the Federal Deposit Insurance Corporation, would consider it too costly to close the bank.²³⁶ When looking solely at the information embedded in share prices, the evidence that this is in fact a motivation for bank mergers is mixed.²³⁷ However, when looking

²³⁰ Dean Foust, *Commentary: If This Safety Net Snaps, Who Pays?*, BUS. WK., Apr. 27, 1998, at 38.

²³¹ *Id.* “We have created financial institutions that are too big to fail,” says Henry Kaufman, the former Salomon Brothers economist known as ‘Dr. Doom’ for saying things the Street doesn’t like to hear. ‘They are not submitted to the full disclosure of the marketplace,’ he adds.” Michelle Celarier, *The God That Failed We Went too far With This’—Felix Rohatyn*, INVESTMENT DEALERS’ DIG., Sep. 9, 2002, at 1.

²³² Foust, *supra* note 230.

²³³ *Id.*

²³⁴ *Id.*

²³⁵ *Id.*

²³⁶ *Id.* at 1.

²³⁷ Edward Kane, *Incentives for Banking Megamergers: What Motives Might Regulators Infer From Event-Study Evidence?*, 32 J. OF MONEY, CREDIT & BANKING 671 (2000) (arguing that evidence showing a positive correlation between equity returns of acquirer and the size of its target supports the view that one motive for bank mergers is to become too big to fail); G. Benston, W. Hunter, & L. Wall, *Motivations for Bank Mergers and Acquisitions: Enhancing the Deposit Insurance Put Option versus Earnings Diversification*, 28 J. OF MONEY, CREDIT & BANKING 777 (1995) (finding that acquirers would not pay more for riskier banks whose returns are correlated with the acquirer’s returns in order to become too big to fail as opposed to banks that offered earnings diversification); and Gayle L. DeLong, *Stockholder Gains From Focusing versus Diversifying Bank Mergers*, 59 J. FIN. ECON. 221 (2001) (reporting no significant relationship between combined bank size and abnormal equity returns realized at the time of the merger announcement for bank mergers occurring in the period 1988 to 1995).

at bond prices, evidence has been found that the desire to become too big to fail is a motivating factor. Research on the relationship between bank mergers and bond prices has shown that medium size banks experienced significant bond returns and realized reductions in costs of funds following announcements that they intended to merge with another bank, particularly when the merger would result in the combined bank's assets exceeding \$100 billion.²³⁸ On the other hand, this research has also shown that mega-banks (those that can be considered already too big to fail at the time of the merger) and smaller banks (combined mean asset size of \$30 billion) earned less return than bondholders of medium-size banks.²³⁹

Evidence of the "too big to fail" mindset in sectors other than banking also exists.²⁴⁰ In late 2001, MJK Clearing ("MJKC"), a medium-size broker-dealer firm headquartered in Minneapolis, was suffering severe financial difficulty.²⁴¹ MJKC's lawyer argued that the firm was too big to fail, that its failure would disrupt economic activity in the Midwest, and that the Federal Reserve Bank of Minneapolis ought to provide it assistance.²⁴² Specifically, it was alleged that MJKC's failure would substantially affect about 200,000 retail customers, several brokerage firms involved in the stock-lending deal that was the original cause of MJKC's financial woes, and a variety of small brokerage houses throughout the Midwest for which MJKC provided back-office services.²⁴³ Ultimately, no assistance was provided and MJKC became the largest liquidation of a securities broker by the Securities Investor Protection Corporation.²⁴⁴ Fortunately, the initial claims of financial and economic disruption proved to be exaggerated.²⁴⁵

Actions such as the rescue of LTCM exacerbate the "too big to fail" mentality within the financial community.²⁴⁶ The LTCM rescue created the perception that the Federal Reserve had assumed responsibility for bailing out large hedge funds when they get themselves into financial difficulties, even though the Federal Reserve lacks any statutory authority to do so. In fact, Federal Reserve Chairman Alan Greenspan has expressly rejected the idea that the Federal Reserve ought to have the power to regulate hedge fund

²³⁸ Maria Fabiana Penas and Haluk Unal, *Too-Big-To-Fail Gains in Bank Mergers: Evidence from the Bond Markets*, 74 J. FIN. ECON. 149, 150-51 (2001).

²³⁹ *Id.*

²⁴⁰ Gary H. Stern and Ron Feldman, *Too Big to Fail: The Hazards of Bank Bailouts*, FED. RES. BANK OF MINNEAPOLIS-THE REGION Dec. 2003, at 60.

²⁴¹ *Id.*

²⁴² *Id.*

²⁴³ *Id.*

²⁴⁴ *Id.* (citing News Release, Securities Investor Protection Corporation, 2001 Set Record for Number of Customers Paid, Amount of Advances, March 13, 2002).

²⁴⁵ *Id.*

²⁴⁶ DOWD, TOO BIG TO FAIL, *supra* note 165, at 2.

activity.²⁴⁷ The Federal Reserve has arguably put itself in the position of being responsible for hedge funds while having no power to regulate them.²⁴⁸ This position allows hedge funds to take large risks that the Federal Reserve cannot prevent, but for which the Federal Reserve will cover the downside risk if the hedge funds find themselves in financial difficulties.²⁴⁹ The Federal Reserve's actions in the LTCM case have raised concerns about whether the Federal Reserve will become responsible for other financial firms. What happens when the Federal Reserve deems a company "too big to fail," and yet the Federal Reserve has no legal authority to regulate that same company?²⁵⁰

C. *Need to Respond to the Globalization of Financial Market.*

Financial service firms, consumers and investors are affected by the globalization of this industry. Large numbers of foreign-owned financial service firms operate in the United States and many American investors seek to purchase foreign securities. The GAO reports that in 2001, 142 U.S. life insurers were foreign-owned companies, slightly more than double the 69 such firms in 1995.²⁵¹ In addition, U.S. investors purchased \$2.5 trillion in foreign securities in 2003.²⁵²

U.S. firms operating abroad must comply with an additional layer of regulation. U.S. regulators are also more frequently participating in international efforts to harmonize financial regulations across countries to enhance the movement of financial goods and services. These efforts are not unlike the early international efforts to harmonize trade regulations that ultimately culminated in the creation of the World Trade Organization.

Regional and international standards for the regulation and supervision of financial services are moving in the direction of greater consistency across the financial services industry. Many U.S. regulators participate in the international forums to harmonize financial regulation, including the Basel Committee on Banking Supervision ("Basel Committee"), the International Organization of Securities Commissions ("IOSCO"), the International Association of Insurance Supervisors ("IAIS"), the Joint Forum, and the Financial Stability Forum ("FSF").²⁵³ The rules developed by these

²⁴⁷ *Id.* at 9.

²⁴⁸ *Id.*

²⁴⁹ *Id.*

²⁵⁰ *Id.* at 10.

²⁵¹ GAO FINANCIAL REGULATION REPORT, *supra* note 8, at 45.

²⁵² *Id.*

²⁵³ *Id.* at 39-40. The OCC, the Federal Reserve, and the FDIC participate as members of the Basel Committee and the OTS has participated as a temporary member. The SEC participates as a

organizations will ultimately influence U.S. regulations in the area of banking, securities and insurance.

The Basel II Accords recognize that banks are increasingly part of broader diversified financial companies, noting:

To the greatest extent possible, all banking and other relevant financial activities (both regulated and unregulated) conducted within a group containing an internationally active bank will be captured through consolidation. Thus, majority-owned or—controlled banking entities, securities entities (when subject to broadly similar regulation or where securities are deemed banking activities) and other financial entities should generally be fully consolidated.²⁵⁴

Basel II requires financial entities that engage in financial leasing, the issuance of credit cards, portfolio management, investment advisory services, custodial and safekeeping services and other similar activities to be captured through consolidation.²⁵⁵

While noting that banks bear the risk for their insurance subsidiaries, Basel II excludes insurance from its definition of financial activities and insurance companies from its definition of financial entities to be captured through consolidation.²⁵⁶ Instead, Basel II recommends that, when measuring regulatory capital, banks with majority-owned insurance subsidiaries should deduct their investments in insurance subsidiaries and significant minority investments in insurance entities from their equity and other regulatory capital.²⁵⁷ In other words, banks would remove from their balance sheets the assets and liabilities as well as any third party capital investments in insurance subsidiaries.

If a bank decides not to follow the recommendation of Basel II and make the recommended deductions, then Basel II recommends that the bank ensure that any alternative approaches it uses will avoid double counting of capital.²⁵⁸ Basel II recognizes that the capital invested by a bank's majority-

member and the CFTC participates as an associate member in the IOSCO. NAIC participates in the IAIS. The Joint Forum was created by the Basel Committee, IOSCO and IAIS to analyze issues, like financial conglomerates, that are not limited to any one financial sector. The Federal Reserve, the SEC and the Treasury participate in the FSF, which promotes financial stability and the reduction of systemic risks.

²⁵⁴ BASEL II CAPITAL ACCORD, *supra* note 1, at 7.

²⁵⁵ *Id.* at 7, n.6.

²⁵⁶ *Id.* at 7, n.5.

²⁵⁷ *Id.* at 8.

²⁵⁸ *Id.* at 8-9.

owned or controlled insurance entity may exceed the amount of regulatory capital required for the insurance entity by the relevant insurance regulator.²⁵⁹ As such, it defines the amount of capital invested by a majority-owned or controlled insurance entity in excess of the legally required regulatory capital as surplus capital.²⁶⁰ Further, Basel II allows for financial supervisors to include such surplus capital from a bank's majority-owned or controlled insurance entity when calculating a bank's capital adequacy under limited circumstances.²⁶¹ Finally, even when a bank's majority-owned or controlled insurance subsidiaries are not included in the bank's consolidated financial statements, Basel II still requires the bank's supervisors to take steps to ensure the capital adequacy of the bank's majority-owned or controlled insurance subsidiaries in order to reduce the chance that these subsidiaries may cause future losses to the parent bank.²⁶²

Even regional efforts to harmonize financial regulations in which the United States is not a direct participant are influencing U.S. financial regulations. The European Union has adopted the Financial Conglomerates Directive ("EU FCD"),²⁶³ which requires supervisors and financial groups to measure, on a consolidated basis, the prudential soundness of groups with significant business in the banking, securities and insurance sectors and that are operating within the European Union.²⁶⁴ The purpose behind the EU FCD is to better assess whether the financial group is a prudential source of weakness as opposed to looking at the individual firms within the group.²⁶⁵ In addition, the amendments to the banking, investment and insurance group directives of the EU FCD are the first steps at the EU level towards treating financial service providers consistently across sectors.²⁶⁶

The EU FCD also requires non-EU financial conglomerates operating within the European Union to have their home country supervisors provide a form of consolidated supervision that is equivalent to that provided by the EU FCD or be supervised on a consolidated basis by a financial supervisor within one of the EU member nations.²⁶⁷ While the US system of supervision requires this in the case of bank holding companies, financial

²⁵⁹ *Id.* at 9.

²⁶⁰ BASEL II CAPITAL ACCORD, *supra* note 1, at 9.

²⁶¹ *Id.*

²⁶² *Id.*

²⁶³ DIRECTIVE 2002/87/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL OF THE EUROPEAN UNION OF 16 DEC. 2002, published in OFFICIAL JOURNAL OF THE EUROPEAN UNION L035, 1 (11 Feb. 2003), available at http://europa.eu.int/eur-lex/pr/en/oj/dat/2003/l_035/l_03520030211en00010027.pdf, [hereinafter the FINANCIAL CONGLOMERATES DIRECTIVE].

²⁶⁴ *Id.* at 2002/87/EC, ch. 2, § 1, Art. 5-9.

²⁶⁵ *Id.* at 2002/87/EC, para. 1-2.

²⁶⁶ *Id.* at 2002/87/EC, para. 3-5

²⁶⁷ *Id.* at 2002/87/EC, ch. 2, § 4, Art. 18.

holding companies, and thrift holding companies, it does not currently require it for financial conglomerates comprised of financial service providers other than banks.²⁶⁸ Many U.S. financial conglomerates that did not qualify as financial holding companies, bank holding companies or thrift holding companies and that operated within the European Union did not want to be subject to the supervision on a consolidated basis by the UK FSA, Germany's BaFin, or a similar regulator in another EU member country. As a result, these firms actively lobbied the SEC to create a new regulatory regime that would allow them to be subject to supervision on a consolidated basis by the SEC. In 2004, the SEC adopted rules that would give financial conglomerates not currently subject to supervision by the Federal Reserve as financial holding companies or bank holding companies or by the OTS as thrift holding companies the option of being classified as supervised investment bank holding companies ("SIBHC"), which would be supervised on a consolidated basis by the SEC.²⁶⁹

Unfortunately, the fractured nature of the U.S. financial regulatory regime has negatively affected efforts by U.S. regulators to participate effectively in international forums. First, the U.S. regulation of insurance at the state level has presented multiple problems in the international context. While the NAIC represents the state insurance regulators at the IAIS, it has no power to bind the state insurance regulators to any proposals developed by IAIS.²⁷⁰ In addition, the NAIC is a cumbersome vehicle for handling international problems in the insurance area, such as the insolvency of Equitable Life. As a result, officials from the EU, UK FSA, and BaFin all informed the GAO that they would prefer to deal with a single insurance regulator at the federal level in the United States rather than continuing to deal with the NAIC.²⁷¹

Second, having multiple U.S. regulators with divergent agendas participating in international negotiations, such as the Basel II Accord, undermines the effectiveness of these negotiators and creates confusion for their counterparts from other countries.²⁷² During the Basel II negotiations, the U.S. regulators lacked a unified position. This lack of a unified position was so troubling to some members of Congress that hearings were held to discuss why the U.S. regulators were unable to better coordinate their efforts.²⁷³

²⁶⁸ GAO FINANCIAL REGULATION REPORT, *supra* note 8, at 5.

²⁶⁹ *Id.* at 7-8.

²⁷⁰ *Id.* at 123.

²⁷¹ *Id.* at 122-23.

²⁷² *Id.* at 122.

²⁷³ GAO FINANCIAL REGULATION REPORT, *supra* note 8, at 8.

D. *Need to Reduce the Likelihood of Agency Capture.*

1. CURRENT SPECIALIZED AGENCIES ARE PRONE TO CAPTURE.

One of the problems discussed in administrative law is the problem of agency capture under the interest group theory on governmental decision-making. Interest group theory generally assumes the following:

- Interest groups seek regulatory decisions that favor the interests of their members;
- Small, narrowly focused interest groups, whose members will receive significant benefits from a particular regulatory decision, are better able to overcome collective action problems to mobilize and advance their interests, which creates a bias for regulation that aids narrow interests;
- Politicians from either the executive or legislative branches try to exchange regulatory benefits for political support from interest groups that are well positioned to provide it; and
- Political control over administrative agencies is sufficient to allow politicians to deliver the type of regulation that the interest groups supporting them seek.²⁷⁴

Agency capture occurs more frequently in agencies that regulate only one special interest group.²⁷⁵ In the financial services industry, specialized agencies, such as the thrift regulators, the bank regulators, the SEC, or the CFTC, are more likely to be captured by the businesses that they regulate than regulators with a broader scope.²⁷⁶

In the thrift savings scandal in the 1980s, research shows that the Federal Home Loan Bank Board was effectively captured by the savings and loan industry.²⁷⁷ In addition, the states that regulated thrifts through a department that focused on the entire spectrum of financial services or several financial services sectors had fewer problems than states like California and

²⁷⁴ Steven P. Croley, *Public Interested Regulation*, 28 FLA. ST. U. L. REV. 7, 15-16 (2000).

²⁷⁵ *Id.* at 103.

²⁷⁶ How much each of these regulators has been captured by their constituents has been debated. Ratner, *supra* note 146, at 1776 ("Unlike the regulators of banks, thrift institutions, and insurance companies, which have acted principally as protectors and advocates for their constituents, the SEC has frequently been at loggerheads with some of the most powerful organizations in the securities industry, particularly the New York Stock Exchange.") *Id.*

²⁷⁷ Joseph A. Grundfest, *Lobbying into Limbo: The Political Ecology of the Savings and Loan Crisis*, 2 STAN. L. & POL'Y REVIEW 25 (1990).

Texas that had set up special agencies to regulate only thrifts.²⁷⁸ Ralph Nader recently compared the behavior of existing bank regulators to those of the savings and loan supervisors in the 1980s, noting that the agencies in both cases had been captured by the businesses that they regulated.²⁷⁹

Wayne Klein, an Idaho regulator who has worked with both the SEC and the CFTC, commented, "The CFTC is just not as aggressive as the SEC. It's too cozy with the industry it regulates, and its record on investor protection is abysmal."²⁸⁰ In the recent accounting scandals involving Fannie Mae and Freddie Mac, OFHEO has been strongly criticized for being captured by the entities that it is supposed to be regulating.²⁸¹

2. AGENCIES THAT CURRENTLY DO NOT CONTROL THEIR BUDGETS ARE MORE PRONE TO CAPTURE.

In addition, agency capture occurs more frequently when efforts to advance general interest regulation to the detriment of special interests would threaten an agency's budget or other institutional interests.²⁸² For example, in response to lobbying by securities firms and corporations, Congress used its control over the SEC's budget in the 1990s to hinder the agency's efforts to enforce the existing securities regulations and to discourage the agency from proposing new, more stringent regulations to protect investors.²⁸³ In response to the public outcry over the Enron and WorldCom scandals, Congress reversed itself and increased the SEC's budget almost 33 percent

²⁷⁸ Ramirez, *supra* note 104, at 554 n.299.

²⁷⁹ Ralph Nader, *The Secret World of Banking, In the Public Interest*, THE NADER PAGE (July 9, 2002), at <http://www.nader.org/interest/070902.html>.

²⁸⁰ Jeffrey Taylor and Jeff Bailey, *CFTC Scrutiny Failed to Halt Trader Accused of Scam*, WALL ST. J. Oct. 4, 1994, at C1.

²⁸¹ Stephen Labaton, *New Agency Proposed to Oversee Freddie Mac and Fannie Mae*, N.Y. TIMES Sept. 11, 2003, at C1.

²⁸² Croley, *supra* note 274, at 15-16; Ramirez, *supra* note 104, at 518.

²⁸³ Stephan Taub, *SEC Boosting Big-Company Caseload*, (March 9, 2004), available at <http://www.cfo.com/article.cfm/3012481?f=advancesearch>. The SEC does not control the amount set for its budget, but must work within the budget established by Congress. SEC, ANNUAL REPORT 2003, APPENDIX, at 142; UK FSA, *Who we are*, at <http://www.fsa.gov.uk/Pages/About/Who/index.shtml> (last visited October 20, 2005); UK FSA, *How we are funded*, at <http://www.fsa.gov.uk/Pages/About/Who/Funded/index.shtml> (last visited October 20, 2005). The amount that the SEC earns in fees in excess of its budget merely becomes part of the general revenues of the federal government. Press Release from the Senate Banking Committee, Schumer, Gramm Introduce Bipartisan Bill to Reduce Section 31 Fees (Jan. 25, 2001), available at <http://banking.senate.gov/docs/cmsa/schumer.htm> (last visited October 20, 2005). During the 1990s, Congress did not allow the SEC's budget to increase in line with the growth in the U.S. securities markets and the corresponding growth in the agency's workload.

to \$716 million in 2003, from the \$540 million that it received in 2002.²⁸⁴ The SEC has requested a budget of \$913 million for fiscal year 2005, which is 69 percent more than its 2002 budget.²⁸⁵ Nevertheless, during the 1990s, the SEC's lack of control over its budget allowed it to be effectively captured by the securities industry that it was supposed to regulate.²⁸⁶

Few federal or state regulators, other than the Federal Reserve, have control over their budgets. Research indicates that the Federal Reserve is less likely to be captured by the banks, bank holding companies, and financial holding companies that it regulates than other U.S. agencies because the Federal Reserve has control over its budget rather than having it set by Congress or a state legislature.²⁸⁷

E. Need to Improve Consumer Protections.

1. REGULATORY COMPETITION PROMOTES A RACE-TO-THE-BOTTOM.

To the extent that the current structure encourages regulatory competition, it generally may be characterized as the detrimental race-to-the-bottom variety, which is harmful to consumers. For example, while striving to achieve reciprocity in the area of insurance regulation, consumer protections were discarded by some states in order to meet the lower standards that other states had enacted. The GAO raised concerns about the fact that some state insurance regulators lack the authority to run criminal background checks on industry applicants, unlike the regulators in the banking, securities, and futures industries.²⁸⁸ The GAO has recommended that states grant their regulators this authority.²⁸⁹ It also noted that the few holdout states that have refused to remove these protections in order to achieve reciprocity are helping their citizens. The GAO stated,

[i]f the objective is more uniformity and reciprocity with an overall improvement in regulatory performance, then the holdout states may be the only defense against the weakening of both regulatory

²⁸⁴ Taub, *supra* note 283.

²⁸⁵ *Id.*

²⁸⁶ One measure of the extent to which the SEC was captured is the number of enforcement cases that it brought during the late 1990s. In 1998, the SEC only pursued 79 financial fraud cases, of which only 5 percent of the total were against Fortune 500 companies. *Id.* In contrast, the SEC brought over twice as many financial fraud cases (199 cases) in 2003, of which 17 percent of the total were against Fortune 500 companies. *Id.*

²⁸⁷ Ramirez, *supra* note 104, at 531.

²⁸⁸ Hillman, *supra* note 155, at 6.

²⁸⁹ *Id.*

oversight and consumer protections. . . . [I]f some states did not object to giving up fingerprinting, for example, as a means of conducting in-depth criminal and regulatory history background checks of agents or company owners and management, consumers would likely be more at risk and regulation would be less effective. In that case, neither uniformity nor reciprocity would represent regulatory progress.²⁹⁰

Obviously, not all states have acted as strong consumer advocates. Only 15 states and cities have adopted laws prohibiting predatory lending.²⁹¹ Pennsylvania overturned a Philadelphia law against predatory lending and Maryland blocked efforts in Baltimore to adopt a law prohibiting predatory lending.²⁹² The fact that most states do not offer consumers protection against predatory lending supports the position that it would be more efficient and effective if a national standard was adopted.

Many of the major consumer protection laws on the books today are federal laws. These laws provide some evidence that consumer protections may increase if regulatory power is moved to the federal level. For example, representatives of the insurance industry have raised concerns that the creation of an optional federal insurance charter would lead to “anti-redlining provisions, unprecedented disclosure and Community Reinvestment Act-like requirements, oversight by the Federal Trade Commission and other federal agencies, expanded privacy provisions, and more.”²⁹³ Most of these items would be considered important federal consumer protection measures.

The dual banking system is often characterized as enabling banks to play regulators against one another and to seek more compatible regulators when they get into trouble.²⁹⁴ Two recent empirical studies offer some insight as to when banks will convert from a national to a state charter. Richard J. Rosen conducted a study that looked at why banks switched primary federal regulators.²⁹⁵ His study examined regulatory switches that occurred between 1983 and 1999. Rosen concluded that his control variables were important

²⁹⁰ *Id.* at 16.

²⁹¹ Predatory lending generally involves lending that targets unsophisticated borrowers, like the elderly and the poor, at high rates and fees and burdensome terms that leave borrowers unable to repay the loans. Jonathan D. Epstein, *Customers Caught in Bank Tug-of-War*, DE NEWS J. (Aug. 10, 2003), at 16C.

²⁹² *Id.*

²⁹³ Letter from Wesley Bissett, Vice President, State Relations and State Government Affairs, Independent Insurance Agents & Brokers of America, to the Honorable Mike Pickens, Commissioner of Insurance, Arkansas Insurance Department (June 3, 2003) (on file with author).

²⁹⁴ Ramirez, *supra* note 104, at 507-08.

²⁹⁵ Richard J. Rosen, *Is There a Crowd? Competition Among Regulators in Banking*, 35 J. MONEY, CREDIT & BANKING 967 (Dec. 2003, Part 1).

predictors of regulatory switches and that banks were most likely to switch federal regulators if they have completed a merger, if they are within a holding company, if they are performing poorly, or if they are larger.²⁹⁶ Rosen notes “much of the explanatory power of the regressions comes from the merger variable and the holding company structure variables,” which conform with the view that most switches are motivated by organizational issues within banks as opposed to other factors.²⁹⁷ Rosen comments that when risk is controlled for within his model, large changes in bank portfolios result in a higher probability of the bank switching regulators.²⁹⁸ From these facts, Rosen concludes that the bank supervisors’ desire for a quiet life results in their preference for banks with a portfolio that is as simple as possible to evaluate and, therefore, bank supervisors will encourage banks that want to make significant changes in their portfolios to change regulators.²⁹⁹

Gary Whalen has raised a number of problems regarding Rosen’s methodology.³⁰⁰ Whalen notes that Rosen’s loan portfolio composition measure is likely to provide a poor indicator of how difficult it is to supervise a bank.³⁰¹ Whalen comments, “[t]he job of supervisors is the easiest at banks that are financially the strongest, and supervisors would prefer all banks to be so. Financial strength is likely to be correlated weakly with changes in loan portfolio composition in general.”³⁰² Whalen goes on to criticize Rosen’s analysis for weighing each of the seven loan categories used in his study equally and states that it “is unlikely that changes in loan portfolio composition attributable to mortgage loans or consumer loans have the same supervisory implications as changes in construction loans.”³⁰³ While Rosen

²⁹⁶ *Id.* at 980.

²⁹⁷ *Id.* at 983.

²⁹⁸ *Id.*

²⁹⁹ *Id.* at 983-84.

³⁰⁰ Gary Whalen, *Charter Flips by National Banks*, (Econ and Policy Analysis Working Paper No. 2002-1, 2002). Whalen’s comments were based on an earlier version of Rosen’s paper, *Is Three a Crowd? Competition Among Regulators in Banking*, PROCEEDING FROM A CONFERENCE ON BANK STRUCTURE AND COMPETITION FEDERAL RESERVE BANK OF CHICAGO (May 2002). Nevertheless, the article that Rosen published in the *Journal of Money, Credit and Banking* does not differ substantially from that earlier paper and Whalen’s critique of Rosen’s research remains relevant. Whalen criticizes Rosen’s models for failing to include any environmental variables and for failing to explicitly take censoring or possible duration dependence into account. Whalen also notes that Rosen’s data is based on pooled annual data that could result in a lag between his explanatory variables and his sample bank flips of between 0 and 12 months and this substantial variation could influence Rosen’s reported results. Whalen also commented that Rosen failed to use any supervisory data to measure the pressure by bank regulators on banks to change their regulators, but instead Rosen relies on changes in the composition of a bank’s loan portfolio and the probability of a charter switch to be positively related. *Id.*

³⁰¹ Whalen, *supra* note 300, at 6.

³⁰² *Id.* at 7.

³⁰³ *Id.*

does classify some loans as “difficult-to-evaluate” and others as easier to evaluate, he does not assign different weights to loans in either category.³⁰⁴

Rosen also noted that a pattern existed pursuant to which banks that were regulated by the Federal Reserve or the FDIC were more likely to switch than banks regulated by the OCC.³⁰⁵ Rosen notes that banks that are increasing the size of their consumer loan portfolio are more likely to shift regulators to the OCC, while banks that are increasing the size of their commercial loan portfolio (including commercial real estate loans) are more likely to shift to the Federal Reserve, and banks that are increasing the size of their real estate construction loan portfolio are more likely to shift to the FDIC.³⁰⁶ From this data, Rosen concluded that each of the federal regulators was specializing in regulating banks with the above mentioned concentrations in their loan portfolios and that this is evidence of regulatory competition leading to optimal standards setting.³⁰⁷ He also noted that this corresponds with regulatory specialization since banks increasing the portion of real estate construction loans in their portfolio are likely to switch to a state charter, while banks increasing the portion of consumer loans in their portfolio are likely to switch to a national charter.³⁰⁸ He assumed that these movements are publicly beneficial because the banks did not fail following such a switch, but rather their revenues generally rose after these moves.³⁰⁹

Rosen, however, fails to account for several factors. First, the fact that the banks’ revenues improved following a switch might be due to the adoption of very profitable, yet questionable practices. For example, banks seeking to engage in substantial consumer lending would want a national charter because it allows them to take advantage of the exportation doctrine. The exportation doctrine, which is embodied in federal banking regulations, allows banks to export the interest rate available in the state in which the national bank processes loans or other transactions and apply it to loans to individuals or entities located throughout the United States. Subprime lenders seek the ability to charge very high rates of interest to certain classes of consumers. By establishing a national bank and processing loans in a state which has no laws limiting the interest rates that may be charged, a bank can engage in subprime lending on a national scale.³¹⁰ Many banks have sought to expand their subprime consumer lending in recent years. Among available

³⁰⁴ Rosen, *supra* note 295, at 979.

³⁰⁵ *Id.* at 980.

³⁰⁶ *Id.* at 990.

³⁰⁷ *Id.* at 969, 990.

³⁰⁸ *Id.*

³⁰⁹ Rosen, *supra* note 295, at 969, 990.

³¹⁰ Elizabeth R. Schiltz, *The Amazing, Elastic, Ever-Expanding Exportation Doctrine and Its Effect on Predatory Lending Regulation*, 88 MINN. L. REV. 518, 522, 544 (2004).

lending methods, subprime lending has the greatest potential to be classified as predatory lending, a practice that is highly undesirable.³¹¹

Second, banks not failing following a switch may be due to the fact that the Depository Institutions Deregulation and Monetary Control Act of 1980 ("DIDMCA") mandates that all depository institutions, regardless of which regulator supervised them, must comply with the reserve requirements set by the Federal Reserve Board of Governors.³¹² Reserve requirements are one of the most important tools used by bank regulators to prevent bank failures. The DIDMCA eliminated the competition between federal and state regulators on the issue of reserve requirements, which had been a major source of state-federal competition prior to 1980.³¹³ Rosen only examined banks that changed their primary regulators from 1983 to 1999.³¹⁴

In addition, converting from a national charter to a state charter or vice versa is a time-consuming and difficult process and banks with problematic CAMELS scores are prevented by regulators from making such a conversion.³¹⁵ "CAMELS" is an acronym for: Capital adequacy, Asset quality, Management administration, Earnings, Liquidity, and Sensitivity to market risk.³¹⁶ Each of these six factors is ranked on a scale of 1 to 5, with 1 being the best score and 5 being the worst. A composite rating is also assigned to each bank under the CAMELS system, which is also on a 1 to 5 scale, with 1 being the strongest performance and 5 signally critically deficient performance.³¹⁷ CAMELS ratings are used by the OCC's examiners to assess a bank's risk management systems.

Rosen had classified real estate construction loans, commercial real estate loans, and commercial and industrial loans as proxies for "difficult-to-evaluate" loans and classified home mortgage loans and consumer loans as proxies for easier to evaluate loans.³¹⁸ Thus, it appears that banks with more problematic portfolios were moving toward state charters while banks with less problematic portfolios were moving toward federal charters.

In the study conducted by Gary Whalen, several indicators of bank risk significantly increased the likelihood that a national bank would exchange its

³¹¹ *Id.*

³¹² Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (codified in scattered sections of 12 U.S.C.); see generally Henry N. Butler & Jonathan R. Macey, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677 (1988) (discussing how the DIDMCA eliminated state-federal competition in the area of reserve requirements).

³¹³ Butler & Macey, *supra* note 312, at 695-96.

³¹⁴ Rosen, *supra* note 295, at 975.

³¹⁵ Butler & Macey, *supra* note 312, at 686-89; Whalen, *supra* note 300, at 17.

³¹⁶ COMPTROLLER'S CORPORATE MANUAL, OFFICE OF THE COMPTROLLER OF THE CURRENCY, A GUIDE TO THE NATIONAL BANKING SYSTEM 20-21 (1999).

³¹⁷ *Id.*

³¹⁸ Rosen, *supra* note 295, at 979.

charter for a state charter.³¹⁹ Charter flips were more likely to occur in more competitive markets and in states where past flip activity was high.³²⁰ In addition, banks were more likely to flip their charter after receiving a less favorable management rating by supervisors.³²¹ Banks also were more likely to flip their charter when their CAMELS ratings worsened or when they became the subject of formal enforcement actions.³²² Whalen admits that his research does not explain the motivations behind such bank charter changes, although he speculates that it might be due either to bank management seeking a more amenable supervisor or to bank supervisors encouraging problem banks to change their charters.³²³ The results of both the Rosen and Whalen studies lend credence to the view that regulatory competition supports a race-to-the-bottom.

2. THE CURRENT REGULATORY STRUCTURE DISCOURAGES INNOVATIONS THAT WOULD BENEFIT CONSUMERS.

The current regulatory structure, particularly with regard to insurance, discourages some forms of product and regulatory innovation. Some products are not brought to market because the costs of overcoming initial regulatory approvals are high, but once achieved, other firms may easily copy the product and sell it themselves. In these instances, the first mover bears the bulk of the costs while later movers reap the financial rewards.

An example of a product that has had its development hampered by the present regulatory structure is that of home equity insurance.³²⁴ For most Americans, the equity that they own in their home is their largest asset. Despite this fact, the average family has almost no access to any form of insurance to protect against adverse fluctuations in the value of their home. There have been a few instances where home equity insurance or home price insurance has been offered, such as in Oak Park, Illinois in the 1970s and in Syracuse, New York beginning in 2002.³²⁵ These programs were sponsored by nonprofit corporations seeking to revitalize distressed neighborhoods by alleviating some of the concerns that people had about losing money on the resale of the homes. Under the Oak Park program, policies would pay out based on the difference between the insured value of the home and the actual

³¹⁹ Whalen, *supra* note 300, at 7-9.

³²⁰ *Id.* at 30.

³²¹ *Id.*

³²² *Id.*

³²³ *Id.*

³²⁴ Andrew Caplin et al., *Home Equity Insurance: A Pilot Project* (Yale Int'l Ctr. for Fin. Working Paper No. 03-12, 2003).

³²⁵ *Id.* at 3, 5.

sales value of the home.³²⁶ Under the Syracuse program, policies would pay out based on changes in a house price index rather than based on the price for which the house actually sold.³²⁷

One of the difficulties encountered by the Syracuse program was determining whether New York would classify the home equity policy as insurance or as a mortgage.³²⁸ The New York State Insurance Commission ultimately opined that the product failed to meet New York's definition of insurance, which required that the insurer pay upon the "happening of a fortuitous event in which the insured has . . . a material interest which will be adversely affected by the happening of such event."³²⁹ The Insurance Commission concluded that the sale of a home was not a "fortuitous event" because the homeowner controlled when he sold and that the homeowner lacked a "material interest" as he did not have a material interest in the index upon which the pay out would be based.³³⁰ The Syracuse program ran into regulatory difficulties when it attempted to write the home equity policy directly into the mortgage for the home, as this violated New York banking regulations against Price-Level Adjusted Mortgages.³³¹ The Syracuse program also determined that the home equity policy did not qualify as a security because it was protecting against a loss rather than in anticipation of making a profit.³³²

Under the current regulatory regime, an insurance company seeking the national introduction of a new product, like the home equity policy, would have to conduct the same legal analysis that the Syracuse program did for all 50 states and the District of Columbia. The first company to introduce this product would bear substantial upfront costs resulting from the necessity of educating insurance regulators about the product's attributes. However, the second company that wanted to sell the same or a very similar product would bear significantly lower upfront costs because it would have to spend considerably less time and money educating the same regulators about the product's attributes. As a result of this situation, useful products may not be introduced into the market because the first insurance company to introduce the product may not realize revenues sufficient enough to offset its higher costs due to the high upfront costs of the initial regulatory approval process.

³²⁶ *Id.* at 5.

³²⁷ *Id.* at 1-2.

³²⁸ *Id.* at 24-26.

³²⁹ *Id.* at 25.

³³⁰ Caplin, *supra* note 324, at 25.

³³¹ *Id.* at 26. A Price-Level Adjusted Mortgage is a mortgage that adjusts its principal based on an index, like inflation. *Id.* at 26 n.14.

³³² *Id.* at 27.

In addition, existing regulators in different agencies are locked into very different views on what types of regulation are appropriate. The SEC's traditional answer to almost every problem was the imposition of greater disclosure requirements.³³³ Bank regulators and insurance regulators are more paternalistic with the types of regulations they impose to ensure the safety and stability of banks and insurance companies.³³⁴ As a result, the existing financial regulators do not tend to be very innovative when thinking about what types of regulations to propose. This lack of regulatory innovation on the part of both federal and state regulators may result in less than optimal regulations which adversely affect both the financial services industry and consumers.

3. CONSUMERS FIND THAT THE CURRENT REGULATORY STRUCTURE IS CONFUSING.

Consumers find the multiple financial regulators confusing.³³⁵ It is not immediately obvious to a consumer which regulator they ought to contact when they have a complaint about a financial service provider. For example, a consumer can both trade securities through and buy insurance from his bank. If he has a problem with an annuity that was sold to him through the bank, it is doubtful that he would immediately know which regulator to call—the OCC or the local state banking regulator, the SEC or the local state insurance commission? The current structure makes it difficult for consumers and investors to seek redress for fraudulent financial activities or to lobby for reforms that would better protect their interests.

F. Need to Provide More Cost Efficient Regulation.

1. THE U.S. FINANCIAL REGULATORY REGIME IS MORE EXPENSIVE THAN THAT OF ANY OTHER DEVELOPED COUNTRY.

The U.S. pays considerably more than any other developed country to regulate its financial services industry. However, it is questionable whether the United States is getting a proportionally better regulatory regime for its money. The UK FSA included in its 2002/03 Annual Report data collected from regulatory authorities in Australia, Canada, France, Germany, Hong Kong, Ireland, Singapore, Sweden and the United States concerning how

³³³ MCCOY, *supra* note 23, § 12.02[2].

³³⁴ *Id.*

³³⁵ GAO FINANCIAL REGULATIONS REPORT, *supra* note 8.

much each spent to operate their financial regulatory agencies.³³⁶ According to the data collected by the UK FSA for comparison with its 2002/03 fiscal year, the total annual regulatory costs incurred by the United States was approximately 12 times more than the total annual regulatory costs for the UK FSA and 86 times more than the total annual regulatory costs for Germany's BaFin.³³⁷

The amount used by the UK FSA actually understates the total annual regulatory costs for the United States because it does not include the amounts spent by federal agencies like OFHEO or the amounts spent by the states for banking and securities regulation.³³⁸ The total regulatory costs for the United States for 2002 would be more than 16 times the annual expenses

³³⁶ 2002-03 U.K. FIN. SERVICES AUTH., ANN. REP. 205-10 [hereinafter UK FSA, ANN. REP.]. The UK FSA raised the following caveats regarding the comparability of the data collected: (1) the figures do not necessarily relate to the same accounting period and may not have been compiled on the same basis; (2) labor and other costs vary between countries; (3) variations in exchange rates will affect the results expressed in a single currency; (4) the scope of the responsibility of the regulatory authorities differ from one country to the next; and (5) the nature and scale of the financial services industries in different countries differs materially. *Id.* at 205.

³³⁷ UK FSA, ANN. REP., *supra* note 336, at 206-07. The UK FSA's fiscal year runs from April 1 to March 31. The amounts cited in the UK FSA Annual Report were in pounds. The total regulatory costs for the United States were £3 billion (approximately \$4.66 billion), the total regulatory costs for the United Kingdom were £249 million (approximately \$385.95 million), and the total regulatory costs for Germany were £35million (approximately \$54.25 million). *Id.*; Federal Reserve Statistical Release, *United Kingdom Historical Rates*, available at www.federalreserve.gov/releases/H10/Hist/dat00_uk.htm (last visited Sept. 4, 2005). The UK FSA indicated that, in most cases, the exchange rate used to convert the amounts into pounds was the rate available on April 7, 2003, although it did not provide the exact U.S. dollar-pound exchange rate that it used. For purposes of this paper, the exchange rate used to convert the amounts cited in the UK FSA's report back into dollars was the U.S. dollar-pound exchange rate for April 7, 2003 of \$1.55 = £1, which was recorded by the Federal Reserve in its Federal Reserve Statistical Release, *United Kingdom Historical Rates*, available at www.federalreserve.gov/releases/H10/Hist/dat00_uk.htm.

Prof. Howell Jackson found that the annual U.S. regulatory costs for the period 1998-2000 were 15 times higher than the regulatory costs for the UK FSA in 2000/01. Howell E. Jackson, *An American Perspective on the FSA: Politics, Goals & Regulatory Intensity*, Address at the Conference of the Center for the Study of International Business Law and the Brooklyn Journal of International Law Symposium: Do Financial Supermarkets Need Superregulators (Sep. 20, 2002). Prof. Jackson found that the regulatory costs per employee were roughly equivalent as the United States spent \$108,525 per employee and the United Kingdom spent \$111,392 per employee. *Id.* He also commented that it was difficult to make comparisons because of the absence of appropriate measures for comparing the securities and insurance sectors and because of the problems of accounting for inter-sector investments and different kinds of assets. *Id.*

³³⁸ UK FSA, ANN. REP., *supra* note 336, at 206-07. In the report, the U.S. total reflects the budgets for the OCC, OTS, FDIC, Federal Reserve, SEC, CFTC, NASD, NYSE, National Futures Association, NCUA, and the state insurance commissions. *Id.* The UK FSA included self-regulatory agencies in its calculations in order to get an amount that corresponded more closely with its regulatory structure, which merged the financial self-regulatory organizations into the UK FSA. *Id.*

of the UK FSA and more than 117 times the annual expenses of Germany's BaFin, if all of the annual expenses for the Federal Reserve, the OCC, the OTS, the FDIC, the NCUA, the SEC, the CFTC, the OFHEO, and the state insurance, banking, and securities agencies were combined.³³⁹

The disparities in regulatory costs between the United Kingdom, Germany and the United States are the greatest in the area of banking regulation. In 2002/03, the total banking assets in the United States were 2.2 times that of the United Kingdom and 2.3 times the total banking assets of Germany.³⁴⁰ However, during roughly the same period, the United States spent 60 times more to regulate its depository institutions than did the United Kingdom and 236 times more than Germany.³⁴¹ The United States'

³³⁹ The total regulatory costs for the U.S. financial regulatory agencies were approximately \$6.4 billion in 2002. 2003 FED. RESERVE BD. OF GOVERNORS, ANN. REP. 288; 2003 FED. DEPOSIT INS. CORP., ANN. REP. 188 [hereinafter FDIC]; 2003 OFFICE OF THE COMPTROLLER OF THE CURRENCY, ANN. REP. 75, 77 [hereinafter OCC]; 2002 OFFICE OF THRIFT SUPERVISION FIN. REP. 3 [hereinafter OTS]; 2002 NAT'L CREDIT UNION ADMIN., ANN. REP. 1 [hereinafter NCUA]; 2002 COMMODITY FUTURES TRADING COMM'N, ANN. REP. 146 [hereinafter CFTC]; 2002 NAT'L ASS'N OF INS. COMMISSIONERS INS. DEP'T RESOURCES REP. 25 [hereinafter NAIC]; 2002 SEC. & EXCHANGE COMM'N, ANN. REP. 180 [hereinafter SEC]; THE CONFERENCE OF STATE BANK SUPERVISORS, A PROFILE OF STATE CHARTERED BANKING 35 (19th ed. 2003); GA. DEP'T OF BANKING & FIN., ANN. REP. 14 (2002); HAW. DEP'T OF COMM. AND CONSUMER AFFAIRS, ANN. COMPLIANCE RESOL. FUND REP. (2002); ILL. ANN. REP. TO GOV. 21 (2002); IND. DEP'T OF FIN. INST., ANN. REP. 16 (2002); IOWA ANN. REP. OF SUPERINTENDENT OF BANKING 27 (2002); MISS. DEP'T OF BANKING & CONSUMER FIN., ANN. REP. 12-14 (2002); N.Y. BANKING DEP'T ORG. & MAINT. REP. 1 (2002); S.C. BOARD OF FIN. INST., ANN. ACCOUNTABILITY REP. 4-5 (2002); VT. ANN. REP. TO THE INS. COMM'R 10 (2002); WASH. DEP'T OF FIN. INST., ANN. REP. 2 (2002); W. VA. ANN. REP. OF FIN. INST. 14, 18, 23 (2002); UK FSA, ANN. REP., *supra* note 336, at 206-07. The total amount for the U.S. state banking budgets, except for South Carolina, was derived from data from THE CONFERENCE OF STATE BANK SUPERVISORS, A PROFILE OF STATE CHARTERED BANKING 35 (19th ed. 2003). A Profile of State Chartered Banking did not contain any information regarding the South Carolina budget for bank supervision. The data for South Carolina was derived from S.C. BOARD OF FIN. INST., ANN. ACCOUNTABILITY REP. 4-5 (2002).

In its 2002/03 Annual Report, the UK FSA obtained the cited amounts from the U.S. agencies. UK FSA, ANN. REP., *supra* note 336, at 206-07. In certain cases, the calculated amounts are hard to determine, because the calculated amounts do not always represent the total agencies' expenses from their annual reports. For example, the total expenses of the Federal Reserve Banks and the Federal Reserve Board equaled \$3.4 billion in 2002. However, the UK FSA lists only £357.9 million, or \$554.7 million, as the regulatory costs for the Federal Reserve Banks and the Federal Reserve Board. UK FSA, ANN. REP., *supra* note 336, at 206-07; 2002 FED. RESERVE BD. OF GOVERNORS, ANN. REP. 288.

³⁴⁰ UK FSA, ANN. REP., *supra* note 336, at 206-07. The total U.S. banking assets for 2002/03 were \$9.67 trillion. *Id.*; Federal Reserve Statistical Release, *United Kingdom Historical Rates*, available at www.federalreserve.gov/releases/H10/Hist/dat00_uk.htm.

³⁴¹ For the year 2002, the total amount spent by the U.S. Federal Reserve, OCC, OTS, NCUA, FDIC, and the state banking regulators was \$4.94 billion, the total amount spent by the UK FSA was \$89.15 million, and the total amount spent by Germany's BaFin was \$20.93 million. UK FSA, ANN. REP., *supra* note 336, at 206-07; 2002 FED. RESERVE BD. OF GOVERNORS, *supra* note 339, at 288; FDIC, *supra* note 338, at 188; OCC, *supra* note 339, at 75, 77; OTS, *supra* note 339, at 3; NCUA, *supra* note 339, at 1;

system costs over 27 times more to regulate banks, thrifts and credit unions than does the United Kingdom system, and over 102 times more to regulate banks, thrifts and credit unions than the German system. This disparity exists even after accounting for the differences in the total banking assets in each country.³⁴²

At least part of the reason for these cost differentials between the United States and both the United Kingdom and Germany can be attributed to the fact that the United States must regulate a much larger number of small and medium-size banks, thrifts and credit unions than either the United Kingdom or Germany. In 2002, the United States had roughly 13 times as many banks, thrifts and credit unions as the United Kingdom.³⁴³ If the number of banks, thrifts and credit unions supervised is taken into account, the United States still spent roughly four times more to regulate each of these institutions than did the United Kingdom.³⁴⁴ In that same year, the

CFTC, *supra* note 339, at 146; NAIC, *supra* note 339, at 25; SEC, *supra* note 339, at 180; THE CONFERENCE OF STATE BANK SUPERVISORS, *supra* note 339, at 35; S.C. BOARD OF FIN. INST., *supra* note 339, at 4-5. The UK FSA in its Annual Report 2002/03 listed the total regulatory costs for the U.S. federal banking, thrift and credit union regulators as £1.4 billion or \$2.17 billion. UK FSA, ANN. REP., *supra* note 336, at 206-07.

³⁴² UK FSA, ANN. REP., *supra* note 336, at 206-07; 2002 FED. RESERVE BD. OF GOVERNORS, *supra* note 339, at 288; FDIC, *supra* note 339, at 188; OCC, *supra* note 339, at 75, 77; OTS, *supra* note 339, at 3; NCUA, *supra* note 339, at 1; CFTC, *supra* note 339, at 146; NAIC, *supra* note 339, at 25; SEC, *supra* note 339, at 180; THE CONFERENCE OF STATE BANK SUPERVISORS, *supra* note 339, at 35; S.C. BOARD OF FIN. INST., *supra* note 339, at 4-5. If the total costs of the U.S. federal banking, thrift, and credit union regulators cited by the UK FSA in its Annual Report 2002/03 are used instead of the total amount of the budgets of the U.S. federal banking, thrift, and credit union regulators and state banking regulators, then the United States' system costs over 12 times more to regulate banks, thrifts and credit unions than the United Kingdom and over 45 times more to regulate banks, thrifts and credit unions than Germany, after accounting for the differences in the total banking assets in each country. The amount in the sentence is based on the total budgets of the Federal Reserve, OCC, OTS, NCUA, FDIC, and the state banking regulators. UK FSA, ANN. REP., *supra* note 336, at 206-07.

³⁴³ In 2002, the United Kingdom had 1,429 banks, building societies and credit unions, while the United States had 19,225 banks, thrifts and credit unions. UK FSA, ANN. REP., *supra* note 336, at 206-07; 2002 FED. RESERVE BD. OF GOVERNORS, *supra* note 339, at 288; FDIC, *supra* note 339, at 188; OCC, *supra* note 339, at 75, 77; OTS, *supra* note 339, at 3; NCUA, *supra* note 339, at 1; CFTC, *supra* note 339, at 146; NAIC, *supra* note 339, at 25; SEC, *supra* note 339, at 180; THE CONFERENCE OF STATE BANK SUPERVISORS, *supra* note 339, at 35; S.C. BOARD OF FIN. INST., *supra* note 339, at 4-5.

³⁴⁴ UK FSA, ANN. REP., *supra* note 335, at 206-07; 2002 FED. RESERVE BD. OF GOVERNORS, *supra* note 339, at 288; FDIC, *supra* note 339, at 188; OCC, *supra* note 339, at 75, 77; OTS, *supra* note 339, at 3; NCUA, *supra* note 339, at 1; CFTC, *supra* note 339, at 146; NAIC, *supra* note 339, at 25; SEC, *supra* note 339, at 180; THE CONFERENCE OF STATE BANK SUPERVISORS, *supra* note 339, at 35; S.C. BOARD OF FIN. INST., *supra* note 339, at 4-5. If the total costs of the U.S. federal banking and thrift regulators cited by the UK FSA in its Annual Report 2002/03 are used instead of the total amount of the budgets of the U.S. federal banking and thrift regulators and state banking regulators, then the United States spent roughly \$216,438 to regulate each of its banks and thrifts or almost twice as much as the United Kingdom

United States had approximately seven times as many depository institutions as Germany.³⁴⁵ If the number of depository institutions being regulated in each country is taken into account, the United States spent 14 times as much as that spent by Germany.³⁴⁶

These large cost disparities give rise to important questions. Is the United States' regulatory regime for depository institutions providing a banking system that is four times more secure than the United Kingdom's system and 14 times more secure than Germany's system? If not, what are the benefits that the United States is deriving from its more costly regulatory system that would justify these expenditures?

The disparities between both the United Kingdom and Germany and the United States are considerably less significant in the area of securities and futures regulation when the size of each country's equity market is taken into consideration. In 2002/03, the United States spent approximately \$1.5 billion on securities regulation (excluding state regulation costs), which was 5.6 times more than that spent by the United Kingdom and 77.6 times more than Germany spent. The total equity market capitalization for that period in the United States was \$10.7 trillion, which was 6.8 times more than that in the United Kingdom and 15.9 times more than Germany's capitalization. Thus, the regulatory costs incurred by the United States at the federal level and the United Kingdom in regulating the securities and futures markets are roughly comparable when the size of each country's markets is taken into account.

That the United States spends significantly more than Germany does to regulate its securities and futures markets is due in part to the fact that a much smaller portion of the general population in Germany owns securities than in the United States. In the United States in 2002, 84.3 million individuals, or 29.2 percent of the total U.S. population, and 52.7 million

spent to regulate each of its banks and building societies in 2002/03. The previous amount is based on the total budgets of the Federal Reserve, OCC, OTS, NCUA, FDIC, and the state banking regulators. UK FSA, ANN. REP., *supra* note 336, at 206-07.

³⁴⁵ Germany had a total of 2,615 registered credit institutions, including banks, savings banks, credit cooperatives, and securities trading banks and spent approximately \$21 million regulating them. UK FSA, ANN. REP., *supra* note 336, at 206-07; 2002 FED. RESERVE BD. OF GOVERNORS, *supra* note 339, at 288; FDIC, *supra* note 339, at 188; OCC, *supra* note 339, at 75, 77; OTS, *supra* note 339, at 3; NCUA, *supra* note 339, at 1; CFTC, *supra* note 339, at 146; NAIC, *supra* note 339, at 25; SEC, *supra* note 339, at 180; THE CONFERENCE OF STATE BANK SUPERVISORS, *supra* note 339, at 35; S.C. BOARD OF FIN. INST., *supra* note 339, at 4-5.

³⁴⁶ UK FSA, ANN. REP., *supra* note 336, at 206-07; 2002 FED. RESERVE BD. OF GOVERNORS, *supra* note 339, at 288; FDIC, *supra* note 339, at 188; OCC, *supra* note 339, at 75, 77; OTS, *supra* note 339, at 3; NCUA, *supra* note 339, at 1; CFTC, *supra* note 339, at 146; NAIC, *supra* note 339, at 25; SEC, *supra* note 339, at 180; THE CONFERENCE OF STATE BANK SUPERVISORS, *supra* note 339, at 35; S.C. BOARD OF FIN. INST., *supra* note 339, at 4-5.

U.S. households, or 49.5 percent of all U.S. households, owned equities, either through individual stocks or through stock mutual funds.³⁴⁷ In Germany, only 9.8 percent of the population owned any stocks directly in 2000, while 23.3 percent of the population of the U.K. owned stocks directly in 1996.³⁴⁸ Both the United States and the United Kingdom regulate their securities markets more intensively than does Germany due to the perceived need to protect the larger number of less sophisticated investors active in the securities and futures markets in these two countries.

Insurance is one area where the duplication of efforts by the individual states in the United States substantially increases costs for both companies and consumers. The regulatory cost disparities between the United Kingdom and Germany and the United States highlight this problem. In 2002/03, the state insurance commissions in the United States spent approximately \$946 million to regulate insurance, which was 30.1 times more than the United Kingdom spent and 70.9 times more than Germany spent.³⁴⁹ These disparities cannot be accounted for solely by taking into account the size of the insurance markets in each country. During the 2002/03 period, the total insurance premiums in the United States equaled \$1.17 trillion, which was 4.9 times more than the \$234.8 billion in total premiums in the United Kingdom and 7.9 times more than the \$146.8 billion total premiums in Germany.³⁵⁰

2. INTER-AGENCY TURF WARS IN THE UNITED STATES WASTE FUNDS.

U.S. regulatory costs are higher than those in other countries not only because of regulatory overlap and duplication, but because of the turf wars in which the agencies frequently engage. Turf wars amongst the federal financial regulators, such as the long-standing battle between the SEC and the CFTC over securities futures, and between the federal regulators and the states have been well documented.³⁵¹ Most of these battles are fought

³⁴⁷ U.S. Census Bureau Population Division, *Time Series of National Population Estimates*, available at http://www.census.gov/popest/archives/2000s/vintage_2002/NA-EST2002-01.html; INV. CO. INST. & SEC. INDUS. ASS'N, *EQUITY OWNERSHIP IN AMERICA*, 1 (2002).

³⁴⁸ Laurence Boone & Natalie Girourard, *The Stock Market, the Housing Market and Consumer Behavior*, OECD ECON. STUD. 175 (2002).

³⁴⁹ UK FSA, ANN. REP., *supra* note 336, at 206-07; NAIC, *supra* note 339, at 25.

³⁵⁰ *Id.* The amount listed in the text is from NAIC. The UK FSA Annual Report stated that the total premiums in the United States for 2002/03 were £581.4 billion, or \$901.2 billion. Using this amount, the U.S. total insurance premiums were only 3.8 times more than the United Kingdom's total insurance premiums and 6.1 times more than Germany's total insurance premiums. UK FSA, ANN. REP., *supra* note 336, at 206-07; Federal Reserve Statistical Release, *United Kingdom Historical Rates*, available at www.federalreserve.gov/releases/H10/Hist/dat00_uk.htm.

³⁵¹ Jerry W. Markham, *Panel I (Part 2): A Comparative Analysis of Consolidated and Functional*

primarily over who should have the authority to regulate a particular type of instrument or entity rather than over whether regulation of the instrument or entity is desirable and, if so, what is the most appropriate form of regulation. Once the decision as to which agency is going to regulate a particular instrument or entity is made, the regulatory biases of that agency usually determine the scope and form that the final regulation takes.

Donald E. Powell, Chairman of the Federal Deposit Insurance Corporation, in a speech at the Exchequer Club on Oct. 16, 2002, explained the costs incurred as a result of agency turf wars when he stated:

All too often, when we engage in turf warfare, the ultimate loser is the industry and the marketplace. The price is paid in lost opportunities and lost competitiveness. The commodity we already lack today—and will increasingly lack in the future—is time. We will no longer have the luxury of lengthy consideration, study, argument, debate, and delay. The industry—and the broader markets—will require answers from the regulators much faster than we can provide them today. In such a market, delay will be as good as denial. A nimble and efficient regulatory structure that evaluates emerging issues—and problems—and moves quickly to address them is going to be increasingly important.³⁵²

Thus, although hard to quantify, turf wars between the states and federal government and the various federal agencies not only waste limited agency resources, but also adversely affect the markets.

3. COMPLIANCE COSTS INCURRED BY THE FINANCIAL SERVICES INDUSTRY EXACERBATE THE PROBLEM.

Simply looking at the amount that state and federal governments spend to regulate financial services underestimates the total costs of the current regulatory regime because it does not capture how much more companies and individuals must pay to operate within the system. The regulatory costs are a fraction of the fees, assessments and taxes that the state and federal governments charge financial service firms. For example, in 2002, state insurance department budgets totaled \$946.6 million while the total revenues

Regulation: Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, the United Kingdom, and Japan, 28 *BROOK. J. INT'L L.* 319, 362 (2003) [hereinafter Markham, *Super Regulator*].

³⁵² Press Release, Donald E. Powell, Chairman of the Fed. Deposit Ins. Corp., *Why Regulatory Restructuring? Why Now?* (Oct. 16, 2002).

generated from fees, assessments, fines, penalties and taxes assessed by states on insurance companies totaled \$12.52 billion.³⁵³ These state insurance department budgets represented only 7.56 percent of the total revenues generated. In order to assess the total costs for the current regulatory regime, the amount spent by firms and individuals in complying with the regulatory requirements of the system must also be taken into account.

In the United States, insurance companies must become licensed in each state in which they want to offer insurance and must obtain authorization from these states for the products they offer. If a new company wants to offer insurance in all 50 states and the District of Columbia, it must apply for a license to operate from each of these 51 jurisdictions, seek advanced approval from each jurisdiction for each of the products that it will offer, and obtain a license for each producer or agent in each state that will sell its products.³⁵⁴ The costs involved in completing the applications for all of these licenses as well as payment of the relevant fees are significant and create a barrier to entry, particularly for small firms. Efforts by the NAIC to encourage uniformity and coordination among states have not met with a great deal of success.

In 2002, the number of domestic insurers (insurers domiciled in the state in which the business is written) in the 50 states and the District of Columbia was 7,090, averaging 139 domestic insurers per state.³⁵⁵ However, foreign insurers (insurers domiciled in a state different from the state in which the business is written) outnumber domestic insurers in every state. On average, 1,357 foreign insurers operate in each state, meaning that, on average, foreign insurers comprise a little over 90 percent of the total number of insurers in any given state.³⁵⁶

If one assumes that states generally charge the same taxes, fees, assessments, fines and penalties to foreign insurers as to domestic insurers, then \$10.88 billion of the \$12.52 billion states earned from taxes, fees, assessments, fines, penalties and other sources were paid by foreign insurers.³⁵⁷ Most of this \$10.88 billion could be saved if insurers only had to pay fees and assessments to the state in which they were domiciled or to a single federal regulator. These added costs create barriers to entry and reduce competition in the insurance sector.³⁵⁸ Compliance costs for other financial

³⁵³ NAIC, *supra* note 339, at 22, 25.

³⁵⁴ BAIR REPORT, *supra* note 23, at 11-12.

³⁵⁵ NAIC, *supra* note 339, at 30, 39.

³⁵⁶ *Id.*

³⁵⁷ *Id.* at 25, 39.

³⁵⁸ BAIR REPORT, *supra* note 23, at 31, 51-52. For example, about 66 percent of the respondents to a recent survey of life insurance providers considered the current state regulatory structure for insurance to impose barriers to entry, particularly for small firms. Out of 383 companies in the life

service providers are equally daunting. According to industry estimates, banking institutions spend approximately \$25 billion annually to comply with federal and state regulations.³⁵⁹

As a result of these barriers, financial service firms will attempt to pass along the costs that they incur in complying with the existing regulatory regime in the United States to their business and consumer clients. Thus, consumers and the U.S. economy as a whole pay a large price for the regulatory structure in place today.

IV. POSSIBLE STRUCTURE FOR THE U.S. FINANCIAL SERVICES AGENCY.

A. *Structure and Operations of the US FSA.*

How should a single U.S. financial services regulator be structured in order to best meet the challenges described above? In general terms, the U.S. should create a single, federal financial services authority that mirrors many of the same aspects of the U.K. Financial Services Authority. This agency should consolidate the regulatory functions of the Federal Reserve, OCC, OTS, FDIC, SEC, CFTC, SIPC, OFHEO, and PBGC, as well as those of the state agencies and commissions that regulate banking, securities, and insurance.³⁶⁰ The merger of all of these agencies would not necessarily be simultaneous, but could be completed in a series of phases. The UK FSA used this stepped method in its combination of different financial regulators.³⁶¹ This approach allows the new agency time to properly integrate

insurance business that received the survey, 129 companies responded. *Id.* at 31.

³⁵⁹ Opening Statement of Chairman Spencer Bachus, *Hearing of Financial Institutions and Consumer Credit Subcommittee on the Financial Services Regulatory Relief Act*, H.R. 1375, 108th Cong. 1 (2003), available at <http://financialservices.house.gov/media/pdf/032703ba.pdf>.

³⁶⁰ I believe that the regulatory functions of OFHEO should be included within the US FSA because the government-sponsored-entities, which OFHEO regulates, comprise some of the large financial conglomerates in the United States. I believe that the regulatory and insurance functions of PBGC should be included in the US FSA because of the impact that these activities have on the segment of the financial services industry that handles employee benefits. Nevertheless, it is beyond the scope of this article to fully analyze why the regulatory functions of these agencies should be included within the US FSA. Instead, this article will focus on the benefits to be derived from consolidating the primary federal and state banking, securities and insurance regulators into the US FSA.

³⁶¹ 2003-2004 FIN. SERVICES AUTH. [FSA], ANN. REP. 50 (U.K.), available at http://www.fsa.gov.uk/pubs/annual/ar03_04/ar03_04.pdf; UK FSA, ANN. REP., *supra* note 336, at 81, 122; 2001-2002 FIN. SERVICES AUTH. [FSA], ANN. REP. 72 (U.K.), available at http://www.fsa.gov.uk/pubs/annual/ar01_02.pdf.

each group of old agencies within its framework without causing major disruptions to any segment of the financial services industry.³⁶²

The Federal Reserve, like the Bank of England, would retain control of its role in formulating monetary policy. Thus, the Federal Reserve would preserve its control over the discount and federal funds rates, its ability to control reserve requirements, and, through the Federal Open Market Committee, its control of the money supply with the purchase and sale of government bonds.

Several reasons exist for maintaining the Federal Reserve as a separate agency responsible for monetary policy. First, this division between the regulation of financial services and the formulation of monetary policy would help both the US FSA and the Federal Reserve achieve clearly defined goals and make the goals of each agency easier to prioritize. Second, combining the power to formulate monetary policy with the power to regulate the entire financial services industry might concentrate too great an amount of power in a single agency. Such a concentration might jeopardize the existing system of checks and balances within the federal government. Third, the former Federal Reserve units would dominate the US FSA if all parts of the Federal Reserve were merged to form the new agency. These units could quite possibly stifle regulatory innovation through their exercise of dominance within the agency in imposing regulatory preferences on other parts of the agency. Fourth, the majority of other nations that have created single, financial regulators have maintained their central banks as separate agencies. This means that there are fewer acceptable models of how to create an integrated financial regulator that incorporates a country's central bank than there are models of an integrated financial regulator not incorporating a country's central bank. As a result of this limitation, the United States may have a more difficult time anticipating and formulating ways to avoid potential problems it may face. Fifth, the US FSA does not need the power to formulate monetary policy in order to meet the challenges facing the financial services industry outlined in Part III. Because of the potential problems posed by an inclusion of the Federal Reserve's monetary functions within the US FSA and the fact that the US FSA does not need these powers in order to address the challenges facing the financial services industry, the US FSA as structured for purposes of this article will not incorporate those functions.³⁶³

³⁶² One of the concerns raised by the creation of the Department of Homeland Security is that attempt to merge over 20 different agencies into one new department at the same distracted these agencies from fulfilling their primary functions. GOV'T ACCOUNTABILITY OFFICE, GAO-03-102, MAJOR MANAGEMENT CHALLENGES AND PROGRAM RISKS: DEPARTMENT OF HOMELAND SECURITY, 3-4 (2003), available at <http://www.gao.gov/pas/2003/d03102.pdf>.

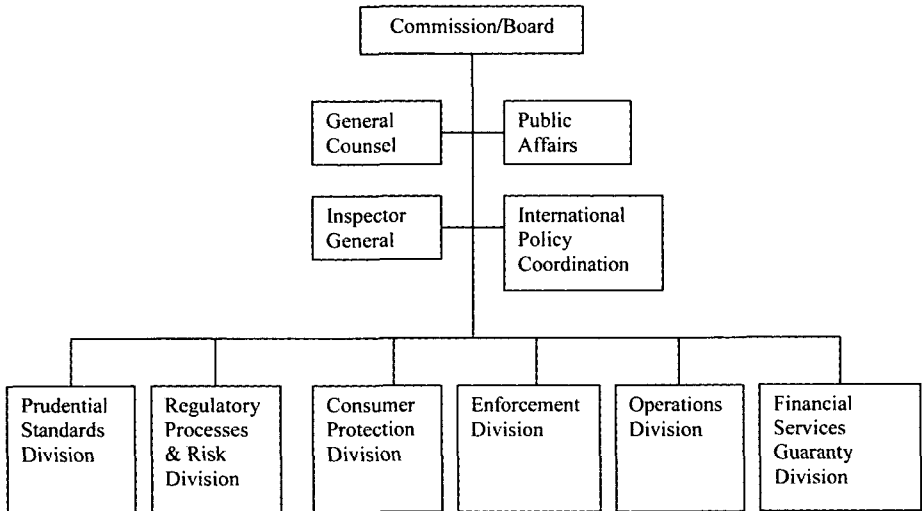
³⁶³ For analyses of what role central banks play in financial supervision, see James R. Barth et al.,

The internal structure of the US FSA should be focused upon supervisory or regulatory objectives, rather than old sectoral lines, in order to best achieve the maximum economies of scale and scope from the merger of existing agencies. For discussion purposes, I would propose that the internal structure of the US FSA include a Prudential Standards Division, a Regulatory Processes and Risk Division, a Consumer Protection Division, an Enforcement Division, and an Operations Division. This structure is an extension of the direction that both the Michigan Office of Financial & Insurance Services and the UK FSA have adopted in their efforts to consolidate financial service industry regulators.³⁶⁴

A Cross-Country Analysis of Bank Supervisory Framework and Bank Performance, 12 FIN. MARKETS, INST. & INSTRUMENTS 67 (2003); Donato Masciandaro, *Central Banks or Single Financial Authorities? A Political Economy Approach*, (Univ. of Lecce, Dep't of Econ., Working Paper No. 47/25, 2004), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=493522.

³⁶⁴ 2000 MICH. OFFICE FIN. & INS. SERVICES, ANN. REP., available at http://www.michigan.gov/documents/cis_ofis_00_full_25416_7.pdf; Michael Taylor, *Accountability and Objectives of the FSA*, in BLACKSTONE'S GUIDE TO THE FINANCIAL SERVICES & MARKETS ACT 2000, at 27-28 (Michael C. Blair et al. eds., 2001).

PROPOSED STRUCTURE FOR THE US FSA



The Prudential Standards Division would develop the prudential standards for both diversified and specialized financial services firms and conduct examinations to determine that firms are complying with these standards. Additionally, this division would conduct research, develop policies, and maintain statistics relevant to safety and soundness concerns. It would also work with institutions that are at risk for financial difficulties to help them remain financially viable. Furthermore, it could take necessary corrective actions to protect investors or consumers or more severe actions, such as seizure, rehabilitation or liquidation, when an entity becomes insolvent.

The Regulatory Processes and Risk Division would regulate financial advice and products, markets, financial reporting, mergers and acquisitions, and develop policies concerning conduct of business issues. The Consumer Protection Division, like the UK FSA’s Consumer, Investment and Insurance Division, would receive and act upon consumer complaints from all financial sectors, which would eliminate the confusion faced by consumers with the vast number of existing hotlines and websites in both state and federal agencies. The Consumer Protection Division would also answer inquiries, approve complaint schemes, and maintain data on companies regarding consumer complaints, how they dealt with complaints, and provide any enforcement actions taken against companies.

The Enforcement Division would handle all enforcement actions for the US FSA. States may continue to prosecute financial service firms and market participants for both fraud and violations of the federal laws and rules governing such companies and individuals. States, however, must coordinate all of their enforcement actions with the Enforcement Division in order to avoid an action by one or more states interfering with another enforcement action by the US FSA or another state. States would also be prevented from attempting to establish new industry standards or rules through enforcement actions not jointly undertaken with the US FSA. Certain types of fraud that take place in nonintermediated markets continue to have a more local or regional character, which makes them appropriate subjects for state-level enforcement actions.³⁶⁵ Such actions, however, should not interfere with the national markets for financial services by attempting to generate new rules governing financial services within a particular state. Any funds recovered by the US FSA and the states for consumer or investor fraud would become part of a fund that would compensate the victims of such crimes rather than becoming part of the general revenues for federal or state governments. Such a fund is not without precedent, as one was established at the federal level by the Sarbanes-Oxley Act of 2002 for victims of securities fraud.³⁶⁶

The Operations Division would consist of the human resources, information technology, finance, and management services. This division would be responsible for establishing and maintaining a single computer network for the US FSA, which would provide a one-stop shop for information on the financial service industry and would aid enforcement efforts by creating a single database containing information about firms or persons who have previously violated any laws or regulations related to the financial services industry. Sharing information between the existing federal and state regulators can be problematic at times because of the different computer systems used and the lack of databases containing information about the financial market participants in certain areas, like banking, on a nationwide basis. This division would also realize cost savings through economies of scale resulting from consolidation of the existing regulatory agencies.

The Financial Services Guaranty Division would fulfill the functions previously performed by the FDIC, the SIPC and the PBGC, as well as those performed by the state insurance guaranty funds. This division would act as a last resort for customers or investors of financial services firms that are members of the funds managed by the division. Additionally, the division would control a deposit insurance fund that would insure deposits in

³⁶⁵ Mark Sargent, *A Future for Blue Sky Law*, 62 U. CIN. L. REV. 471, 504-05 (1993).

³⁶⁶ See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

depository institutions for up to \$100,000. It would administer a securities insurance fund that would work to return the cash, stock and other securities held in an investor's account at a bankrupt brokerage firm up to a limit of \$500,000. Finally, the division would manage funds that guarantee pension benefits against insolvency and cover the claims of policyholders and claimants of insurance companies that have become insolvent.

A Board of Directors with a strong chairman should manage the US FSA. The number of directors should be large enough to represent a range of opinions and interests but not so large as to be unwieldy and counterproductive. As a basis for comparison, federal agencies that regulate the financial services industry generally have between three to seven members of the board. A board comprised of fewer than five directors would probably not provide the diversity of views necessary to fully consider new regulations for financial products and services. Alternatively, a board comprised of more than 16 directors would likely make it too difficult to make decisions quickly enough to respond to the rapid changes in the marketplace.

For purposes of this article, I will assume that the board of the US FSA would be structured similarly to the board of the Federal Reserve, which has seven directors. Like the SEC, the CFTC and the FTC, I will assume that the term for the directors will be five years. Also like the SEC, the CFTC, the FTC, and the NCUA, only a slight majority of the directors may come from the same political party, so as to avoid a partisan bias on the board. To ensure this goal, this article proposes that only four of the seven directors of the US FSA may come from the same political party. As with most federal financial service regulators, all of the directors would be nominated by the President and approved by the Senate prior to taking office.

Each director will have a small staff at their disposal to help them effectively oversee the operations of the agency. All Federal Reserve staff members work primarily for the chairman while other directors generally are only allotted one secretary and perhaps one other aide.³⁶⁷ As a result, other directors at the Federal Reserve are more constrained than the chairman in their ability to stake out their individual positions. By providing the directors of the US FSA with more extensive human resources, the US FSA would hopefully benefit from a vigorous debate over the proper type and level of regulation when policy goals concerning the financial services industry conflict.

In order to foster such debates, the division proposing new regulations to be considered for approval by the directors would be required to submit these proposals for review and comment by each of the other divisions,

³⁶⁷ MARTIN MAYER, *THE FED* 304 (2001).

excluding the Operations Division. Although the other divisions would not have a veto right over the proposed regulations, their comments would be provided to the directors for their consideration and would become part of the public record. Regulations would only become final after approval by a majority vote of the US FSA's board of directors.

The new US Financial Services Agency would be funded by fees charged to those institutions that it regulates. This practice is not unusual, and is in fact, utilized by both the Federal Reserve and the UK FSA. This revenue would be more [than] sufficient since it is the case that most U.S. financial regulatory agencies and the UK FSA generate more revenue from fees than they need to fund their operations.³⁶⁸

B. *Accountability Safeguards for the US FSA.*

Obviously the size and power of the US FSA raise concerns about how to ensure accountability and responsiveness to the needs of American businesses, consumers, and investors. The US FSA would be directly accountable to Congress and would be required to file an annual report with Congress describing its activities over the past year as well as its plans for the future. Additionally, it also would be required to make periodic reports to both the House Committee on Financial Services and the Senate Committee on Banking, Housing and Urban Affairs and to testify before other Congressional committees when necessary. This would serve to make the activities of the US FSA more transparent than many state agencies, which are not required to produce any reports detailing their actions and expenditures.

The US FSA should establish two advisory groups, one comprised of representatives for consumers and one of representatives from financial services firms. These groups would offer advice to the US FSA on pending regulatory matters and publish reports giving their independent assessments of how well the agency is achieving its statutory objectives. Both the Federal Reserve and the UK FSA employ similar panels.

Like many other federal agencies, the US Financial Services Agency would benefit from operating multiple offices spread throughout the country. The US FSA would have specialists in each office that would conduct examinations of financial institutions and investigate violations and consumer complaints for that region. These offices would allow the US FSA

³⁶⁸ UK FSA, ANN. REP., *supra* note 336; 2002 FED. RESERVE BD. OF GOVERNORS, *supra* note 339; FDIC, *supra* note 339; OCC, *supra* note 339; OTS, *supra* note 339; NCUA, *supra* note 339; CFTC, *supra* note 339; NAIC, *supra* note 339; SEC, *supra* note 339; THE CONFERENCE OF STATE BANK SUPERVISORS, *supra* note 339.

to be more responsive to the concerns of both financial firms and consumers across the United States than it would be if it operated solely out of a Washington, D.C. office.

Additional details regarding the structure of the US FSA would need to be worked out before the organization could be established. Nevertheless, this outline of the basic structure provides us with sufficient information to assess the benefits of such a structure over the current regime.

V. ADVANTAGES OF A SINGLE FINANCIAL REGULATOR

The advantages of the US FSA all relate to the fact that it would equip the United States to more constructively address each of the major challenges facing the financial services industry. Comparable benefits cannot be realized under the present regime or under the three options proposed by the GAO.

A. *US FSA Would Monitor Risks Across Firms and Sectors and Address Such Risks Strategically.*

1. **US FSA WOULD CREATE A PERMANENT SYSTEM FOR COORDINATION AND COOPERATION CONCERNING REGULATORY GOALS FOR THE ENTIRE FINANCIAL SERVICES INDUSTRY.**

The US FSA would create for the first time in the United States a permanent system for coordination and cooperation concerning regulatory goals across the financial services industry. The US FSA would operate more effectively than the FFIEC and the other ad hoc organizations because it would be able to approve and implement regulations dealing with cross-sectoral issues without having to rely on separate agencies following through on their commitments. It would also cover all financial services sectors rather than just the banking regulators as the FFIEC does. Further, since the US FSA is not just adding another layer of bureaucracy on top of several existing agencies, it would be more efficient and cost effective than would be an expansion of the FFIEC to include more state and federal regulators. The US FSA would also be more effective than the functional consolidation option, twin peaks option or financial conglomerate agency option, which were proposed by the GAO and which would still require multiple agencies to act cooperatively in coordinating their regulations.

2. US FSA WOULD HARMONIZE REGULATIONS ACROSS SECTORS AND ELIMINATE DUPLICATIVE REGULATIONS.

One of the objectives of the US FSA would be to review existing regulations and attempt to harmonize them so that they can be applied more consistently and uniformly. This is a feasible outcome, as the UK FSA was successful in achieving its goal of reducing the number of regulations governing financial service firms in the United Kingdom.³⁶⁹ For example, the UK FSA shortened the Code of Market Conduct by 30%, reduced the listing rules for new securities by 40%, and cut 200 pages from the provisions on collective investment schemes.³⁷⁰

The United States should be able to achieve this goal as well, particularly when one considers the fact that the implementation of a single, federal regulator would immediately eradicate a significant number of the inconsistencies and inefficiencies in the current system. Simply by creating a national regime for insurance, a federal regulator could substantially reduce the inconsistencies and duplication of regulation of insurance providers and insurance products.³⁷¹ The United States would also benefit from the standardization of regulations that affect other financial products and companies. Nevertheless, this rationalization process will not happen overnight, but probably will require several years to complete.³⁷²

The creation of the US FSA would eliminate the debate over which agency was accountable for hybrid products and firms or for situations like the stock market bubble of the late 1990s. The new agency would be more likely than the existing system to investigate whether new products or firms ought to be regulated and the appropriate type of regulation needed as, currently, agencies shirk responsibility by arguing that the product or firm fell outside of their jurisdiction. This debate over hybrid products would

³⁶⁹ 58 FSA HANDBOOK DEV. 2 (2004), available at <http://www.fsa.gov.uk/pubs/handbook/HB58.pdf>.

³⁷⁰ *Id.*

³⁷¹ BAIR REPORT, *supra* note 23, at i-ii.

³⁷² José de Luna Martínez & Thomas A. Rose, *International Survey of Integrated Financial Sector Supervision* 13 (World Bank, Fin. Sector Operations & Pol'y Dep't, Working Paper No. 3096, 2003), available at http://www.wds.worldbank.org/servlet/WDScontentServer/WDSP/IB/2003/08/23/000094946_03080904015686/Rendered/PDF/multi0page.pdf. The Martínez and Rose survey found that few of the nations that had adopted integrated supervision had been able to harmonize regulations and supervisory approaches across the financial services industry, although they did find a greater degree of consistency between the regulation and supervision of banks and securities firms than banks and insurance companies. Martínez and Rose speculated that the reasons for this was the relative newness of the agencies involved, which were generally less than five years old, and the lack of consistency of international standards across the financial services industry.

likely continue if any of the other three options proposed by the GAO were implemented.

The US FSA will also be more willing to consider innovative ways of dealing with problems arising within the financial services area, such as stock market bubbles. Consolidation of the different agencies into the US FSA will expose regulators to different regulatory methods as existing agencies tend to rely only on a limited set of regulatory tools, which are products of each agency's history and regulatory priorities. As a result, the existing agencies are not very innovative when considering possible regulatory approaches for new problems. Exposure to other regulatory methods may have a synergistic result, resulting in more innovative ways of dealing with market failures and other problems. The functional consolidation option and the financial conglomerate agency option would not offer this benefit, but would only maintain the current regulatory preferences. Additionally, the functional consolidation option would create a federal agency for each financial sector. These federal agencies would simply consolidate the preference for disclosure in the securities area into an agency and the preference for prudential examinations in the banking area. These agencies would lack the synergies that can accrue from bringing experts from different regulatory backgrounds together. Finally, the financial conglomerate agency option would keep all of the existing regulators in place but merely add a new agency to the mix to deal with financial conglomerates.

Given the size and breadth of the US FSA, the head of this agency would likely have the same standing as the current Federal Reserve chairman in being able to use his persuasive authority to talk the market down in the event of another financial bubble, such as the one that developed in the stock market in the late 1990s. None of the other options proposed by the GAO would create an agency that would control the same stature and moral authority as that which the Federal Reserve possesses.

B. US FSA Would Regulate Financial Conglomerates More Effectively.

1. US FSA WOULD BETTER ADDRESS THE CONFLICTS OF INTEREST CREATED BY FINANCIAL CONGLOMERATES.

The US FSA would be better equipped to develop appropriate regulatory responses to the financial conglomerate conflict of interest problems than the current structure because these conflicts frequently involve more than one financial sector. Under the current regulatory structure, fashioning an appropriate response to such conflicts would require the cooperation of several regulators. These regulators may view the relative importance of a problem differently based on the objectives of their agencies and, thus, may

be less willing to cooperate and focus on a specific problem than would other regulators. The board of directors of the US FSA would be able to sort out conflicting regulatory goals and to prioritize responses to the problems created by the conflicts of interests within financial conglomerates, while avoiding the agency deadlock or agency capture problems seen in the current system.

For example, with regard to the problem of tying bank loans to investment banking business, the US FSA would be ideally situated to examine the inconsistent laws and regulations that permit tying as long as the loan is booked through a holding company or a securities subsidiary rather than directly by the bank. The US FSA could then develop a plan to harmonize these laws and regulations so that all firms operate on a level playing field. Any new regulations regarding tying would be reviewed and commented upon by the Enforcement Division of the US FSA, which may be better positioned than existing regulators to suggest ways of making the rules more enforceable than those currently in place.

The other regulatory reform options proposed by the GAO would be less successful than the US FSA at developing appropriate regulatory responses for financial conglomerates. The functional consolidation option would still require the three new federal financial regulators for banking, insurance and securities to work cooperatively in devising regulations for financial conglomerates. While it is certainly easier to coordinate three agencies than it is to coordinate over 115, turf wars could still arise, undermining their effectiveness in developing regulations for financial conglomerates. However, the same problems are posed by the twin peaks option, but instead of three agencies quarrelling with each other over regulations, only two agencies would be fighting. The financial conglomerate agency option would create a new entity to regulate financial conglomerates, but would leave existing regulators in place. As a result, problems would arise regarding which entities are classified as financial conglomerates and, thus, fall within the scope of the new agency as opposed to those being regulated by one of the existing financial regulators. The US FSA would avoid these problems because, to the extent that similar issues may arise between units within the US FSA, the US FSA Board of Directors would be able to come to a resolution more quickly and efficiently than could any process of inter-agency negotiation or litigation. Therefore, the US FSA would be a better regulator of financial conglomerates than the other options proposed by the GAO.

2. US FSA WOULD BE BETTER ABLE TO ADDRESS THE “TOO-BIG-TO-FAIL” PROBLEM POSED BY FINANCIAL CONGLOMERATES.

The US FSA would be better able to deal with the “too-big-to-fail” problem than the existing regulatory structure for three reasons. First, by removing the Federal Reserve as a financial regulator, it would remove a major incentive for the Federal Reserve to intervene in order to save failing institutions. The Federal Reserve may have concerns about the damage to its reputation caused by the failure of a bank under its supervision. Thus, the Federal Reserve is more likely to attempt to save a troubled bank than it is to save a bank under the supervision of another regulatory agency.

Second, the creation of the US FSA would make one agency accountable if a financial conglomerate fails. The US FSA would be more diligent about supervising troubled institutions and making certain that they are closed down at an appropriate time because it would be held accountable by Congress if it failed to act as such. As noted in Part II, the current structure permits some financial conglomerates to be regulated by different state and federal agencies on a consolidated basis, while other financial conglomerates are not regulated in this fashion. The US FSA would be solely responsible for regulating financial conglomerates and could be held accountable if it failed to do so properly.

Third, because the US FSA would be a new agency, strong prohibitions denying it the power to bail out large financial conglomerates could be put in place. This would not prevent Congress from moving to rescue large, failed institutions, but such instances are likely to occur less frequently than agency sponsored rescues because of the difficulty in obtaining the requisite majority vote in Congress.

The US FSA would be better equipped to deal with the “too big to fail” problem than the other formulations proposed by the GAO because none of these options makes a single agency accountable if a financial conglomerate fails. If a financial conglomerate fails, responsibility would be divided among three agencies under the functional consolidation option and two agencies under the twin peaks option. The financial conglomerate agency option would attempt to make the new agency primarily responsible for financial conglomerates but the existing financial regulators would continue to play some role in the regulation of those entities. This lack of alignment might undermine the ability of holding the new agency accountable if a financial conglomerate fails.

C. *US FSA Would Respond More Effectively to the Globalization of Financial Market.*

The US FSA would always maintain a unified position in international negotiations, which would avoid embarrassing situations, such as those occurring during the Basel II negotiations where different regulators from the United States argued for different proposals. To the extent that divisions within the US FSA might have different views on what the U.S.'s position should be, those differences could be discussed and a unified position negotiated within the agency before entering into negotiations with other countries.

The US FSA would also be able to respond to international developments more quickly, because the head of the US FSA could resolve disputes within the agency over the appropriate response to a problem. Under the current system, no mechanism exists to resolve interagency disagreements in a timely manner. As a result, the US FSA would be able to help American financial firms take advantage of the potential benefits that result from globalization.

The foregoing advantages are not available under any of the options proposed by the GAO. Under all of the other options, different regulators might have very different positions from one another. None of the other options provide as efficient a mechanism for resolving the differences over negotiating positions as does the US FSA.

D. *US FSA Would Be Less Prone to Agency Capture.*

Several factors either mitigate or eliminate the problem of agency capture as a concern when forming a U.S. Financial Services Agency. As noted above, agency capture occurs less frequently in agencies that regulate several competing interest groups.³⁷³ An agency, like the US FSA, that regulates a wide range of businesses and sectors, is less likely to be captured because the interests of the different businesses and sectors will generally be at odds with one another and will, in part, cancel each other out.³⁷⁴ In addition, the US FSA would be less likely to be subject to capture by certain sectors within the financial services industry because its internal structure would be based on

³⁷³ See discussion *supra* Part III.D.1.

³⁷⁴ California recently decided to consolidate many of its agencies in order to take advantage of the reduction or elimination of the agency capture problem. CAL. PERFORMANCE REV. COMM'N, CAL. PERFORMANCE REV., THE PUBLIC PERSPECTIVE (2004), available at http://cpr.ca.gov/updates/archives/pdf/10_20_2004/Public_Perspective/Public_Perspective_Full_Report.pdf; John M. Broder, *Plan Would Consolidate California Agencies*, N.Y. TIMES, Aug. 4, 2004, at A15.

regulatory goals, such as prudential concerns, rather than industry segments, such as insurance.

The US FSA is also less likely to be captured by financial conglomerates because market forces will ensure that a diverse mix of businesses will comprise the U.S. financial services industry in the future. To date, the data suggests that some firms are more profitable when they operate as conglomerates while others are more profitable when they operate in specialized areas.³⁷⁵ In the finance literature, the conglomeration hypothesis states that conglomerates will maximize value by running various businesses that, together, can achieve both cost scope economies, through sharing certain inputs, and revenue scope economies, by being able to charge clients more for the convenience of providing "one-stop shopping."³⁷⁶ The strategic focus hypothesis states that firms specializing through focusing specifically on core businesses and core competencies will maximize value.³⁷⁷ If only the conglomeration hypothesis proves correct, then firms would tend over time to move toward becoming conglomerates.³⁷⁸ However, if only the strategic focus hypothesis is correct, then firms would tend over time to become more specialized.³⁷⁹ The reason for these trends is that the other strategies would prove to be inefficient and firms would be compelled by market forces to either change their strategies or to go out of business.³⁸⁰

Research on companies in the U.S. insurance industry (which allows firms to sell both life insurance and property-liability insurance) provides evidence that specialist firms can coexist with firms that operate in both insurance lines, referred to as joint producers.³⁸¹ The insurance sector's profit scope economies, which take into account both costs and revenues,

³⁷⁵ Allen N. Berger et al., *Conglomeration versus Strategic Focus: Evidence from the Insurance Industry*, 28 (Univ. Pa. Wharton School Fin. Inst. Center, Working Paper No. 99-29-B, 2000), available at <http://fic.wharton.upenn.edu/fic/papers/99/9929.pdf> [hereinafter Berger et al.].

³⁷⁶ *Id.* at 1; David J. Teece, *Economies of Scope and the Scope of Enterprise*, 1 J. OF ECON. BEHAV. & ORG. 233, 233-47 (1980); Richard J. Herring & Anthony M. Santomero, *The Corporate Structure of Financial Conglomerates*, 4 J. FIN. SERVICES RES. 471, 471-97 (1990); John G. Gallo et al., *Commercial Bank Mutual Fund Activities: Implications for Bank Risk and Profitability*, 20 J. OF BANKING & FIN. 1775, 1775-91 (1996); Charles W. Calomiris, *Universal Banking "American Style"*, 154 J. OF INST. & THEORETICAL ECON. 44, 44-60 (1998).

³⁷⁷ Berger et al., *supra* note 375, at 2; Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers*, 76 AM. ECON. REV. (PAPERS & PROC.) 323, 323-29 (1986); Yakov Amihud & Baruch Lev, *Risk Reduction as a Managerial Motive for Conglomerate Mergers*, 12 BELL J. OF ECON. 605, 605-17 (1981); Margaret Meyer et al., *Organizational Prospects, Influence Costs, and Ownership Changes*, 1 J. OF ECON. & MGMT. STRATEGY 9, 9-35 (1992).

³⁷⁸ Berger et al., *supra* note 375, at 2.

³⁷⁹ *Id.*

³⁸⁰ *Id.*

³⁸¹ *Id.* at 28.

suggest that conglomerates and specialist firms can coexist. This is so because the conglomeration hypothesis is valid for large joint producers emphasizing personal lines of business and firms utilizing vertically integrated distribution systems while the specialization hypothesis is valid for small and medium-sized insurers emphasizing commercial lines and firms utilizing non-integrated distribution systems.³⁸² As a result, the market forces in the insurance sector will encourage the continued coexistence of both joint producers and specialized firms.

Agency capture occurs more frequently when efforts to advance general interest regulation to the detriment of special interests would threaten an agency's budget or other institutional interests.³⁸³ Most countries that have created a single financial regulator have allowed the regulator's budget to come out of the fees that it charges.³⁸⁴ Thus, such agencies operate like the Federal Reserve, which has control over its budget and is not constrained by a budget imposed by Congress. Research indicates that the Federal Reserve has been less likely than other U.S. agencies, such as the SEC whose budget is set by Congress, to be captured by the banks, bank holding companies, and financial holding companies it regulates.³⁸⁵

The functional consolidation and financial conglomerate agency options both create agencies that are more likely to be captured by certain segments of the financial services industry than would be US FSA. The twin peaks option offers benefits similar to those offered by the US FSA because it creates two agencies covering the entire financial services industry and, thus, would be less prone to capture than the existing agencies or the other two options proposed by the GAO.

E. US FSA Would Improve Consumer Protections.

The creation of the US FSA would benefit consumers in several ways. First, by merging the existing regulators and ending duplicative regulations, the US FSA would reduce the cost of bringing new products and services to market. Second, by merging the existing regulators, the US FSA would encourage innovation in the kinds of regulations employed, which would lead to better, more cost efficient regulations. Third, by creating a single database used to track people and firms who have violated financial laws and regulations, the US FSA would be more effective in deterring financial crimes, enforcing the laws and regulations, and ensuring consumer

³⁸² *Id.* at 27.

³⁸³ Croley, *supra* note 274, at 15-16; Ramirez, *supra* note 104, at 541-42.

³⁸⁴ See, e.g., *About the FSA: Who are we: How we are funded*, available at <http://www.fsa.gov.uk/Pages/About/Who/Funded/Index.shtml> (last modified Apr. 4, 2005)

³⁸⁵ Ramirez, *supra* note 104, at 541-42.

protection. Finally, by creating the Consumer Protection Division within the US FSA, the agency would be more likely to take into account consumer protection concerns than would some of the existing agencies.

1. US FSA WOULD END THE REGULATORY RACE-TO-THE-BOTTOM.

The US FSA would end the race-to-the-bottom phenomenon because firms would no longer be able to play one regulator off against another. In addition, by clearly articulating consumer protection as one of the agency's goals, the agency will be held accountable for its progress in this area. As outlined in Part IV, the Consumer Protection Division would be the internal agency that ensures consumers are heard. States would continue to be able to protect their citizens through the enforcement of federal laws and regulations, but would no longer be able to disrupt financial markets by enacting conflicting laws and regulations.³⁸⁶

The experience of the UK FSA provides reason to believe that the US FSA would improve consumer protection. During its first three years of existence, the UK FSA has been successful at meeting its goal of protecting consumers. In fact, the Financial Services Practitioner Panel for the UK FSA reported in December of 2004 that some practitioners were concerned that the UK FSA was too focused on protecting consumers.³⁸⁷

Under both the functional consolidation option and the financial conglomerate agency option, firms would still be able to play one regulator off another. Under the functional consolidation option, the opportunities to do so would be substantially reduced but would still exist. Why? The financial conglomerate agency option would allow all of the 115 existing regulators to continue to operate, ensuring a continuation of the problem. Among these options, the twin peaks option would provide an outcome that would come close to achieving the benefits of the US FSA as it would create two agencies having significantly different regulatory goals, one focusing on prudential issues and the other on market issues. As a result, the opportunities to play these two agencies off against one another would be very few. The US FSA as a single regulator would still be marginally better than the twin peaks option as it would eliminate the ability of financial firms to pit different agencies against each other and thus, would avoid the race-to-the-bottom that could exist with any of the other options.

³⁸⁶ Butler and Macey noted that many of the banking laws, like the Glass-Steagall Act and the McFadden Act, were originally designed to protect banks from competitive pressures. Butler & Macey, *supra* note 312, at 693. For example, the anti-branching state laws allowed local state regulators to protect local bank monopolies.

³⁸⁷ 3 FIN. SERVICES PRAC. PANEL SURV. FSA'S REG. PERFORMANCE (2004), available at http://www.fs-pp.org/uk/docs/surveys/2004performance_report.pdf.

2. US FSA WOULD ENCOURAGE INNOVATIONS THAT WOULD BENEFIT CONSUMERS.

The US FSA would be more likely to encourage innovative products, like the home equity policy, because the initial approval process would be considerably cheaper and faster. Under this system, the first company seeking to offer a new product would only have to submit one application to the US FSA rather than having to contact state insurance, banking and securities regulators in all 50 states and the District of Columbia.

A second way that creation of the US FSA would encourage innovation is in the way products and firms are regulated. As previously noted, existing regulators tend to have a preferred regulatory method and do not give adequate consideration to other methods that may prove more effective.³⁸⁸ Under the structure proposed for the US FSA in Part IV(A), consolidating the existing agencies into the US FSA would result in the prudential regulators from the banking, insurance and securities sectors being combined into the Prudential Standards Division and the conduct of business regulators from those sectors being combined into the Regulatory Processes and Risk Division. In both of these new divisions, these regulators would expose each other to different ways of viewing prudential or conduct of business regulatory challenges. Additionally, the US FSA would encourage cooperation and discourse among all of its divisions, enhancing the potential for regulatory synergies and the emergence of innovative regulatory processes.

The potential for these types of synergies is displayed in the regulatory proposals made by personnel that have moved from one regulatory agency to another. The proposal by Cynthia Glassman, a senior economist at the Federal Reserve Board and a recess appointee to the SEC, to require disclosure of CAMELS ratings is an example of this phenomenon. In 2002, she proposed that CAMELS ratings issued by both state and federal bank regulators be disclosed to the public.³⁸⁹ Her suggestion was not the first time that such a disclosure had been recommended.³⁹⁰ Nevertheless, Ms. Glassman acknowledged that her willingness to consider such a disclosure was a product of her move from one agency, the Federal Reserve, to another, the SEC.³⁹¹ The SEC has a different perspective regarding financial

³⁸⁸ See discussion *supra* Part III.E.2.

³⁸⁹ Rob Blackwell, *Camels Score Disclosure Back in Play*, [2002] *AM. BANKER* 1; Nader, *supra* note 279.

³⁹⁰ Both former FDIC Chairman William Isaac and former FDIC Chairman L. William Seidman had supported disclosing CAMELS scores in the 1980s. Blackwell, *supra* note 387, at 1.

³⁹¹ The banking industry representatives strongly oppose CAMELS scores being disclosed on the

regulations than does the Federal Reserve and is not as beholden to the banks as is the Federal Reserve.

In all but the financial conglomerate agency option, the initial approval process for products and services likely would be completed in a more cost efficient manner and with greater expediency than under the current regime. It would not be faster under the financial conglomerate agency option because that option retains all existing regulators and adds another agency to deal with financial conglomerates. Thus, the approval process for products and services likely would remain relatively unchanged under that option.

The US FSA, however, would more effectively encourage regulatory innovations than would either the functional consolidation option or the financial conglomerate agency option because it would expose regulators to different types of regulation. The twin peaks options might result in benefits similar to those realized under the US FSA because the two agencies would also be regulating certain types of risks rather than entities or products. Nevertheless, the two agencies created under the twin peaks option might be marginally less innovative than the US FSA as the regulators dealing with different types of risks would interact with one another less frequently due to their placement in separate agencies. As a result, fewer synergies and correspondingly fewer innovations may result when financial regulators operate out of two agencies.

3. US FSA WOULD PROVIDE CONSUMERS WITH A ONE-STOP SHOP FOR INFORMATION ABOUT, AND PROTECTION FROM, THE FINANCIAL SERVICES INDUSTRY.

By eliminating the confusing array of agencies regulating financial services and creating a single agency to which complaints may be reported, the US FSA would make it easier for consumers to seek redress against financial service companies. Local offices and a national call center would make it easier for consumers to determine which agency to contact in order to seek the help they require.

The US FSA can draw on the experiences of the OCC and other regulators that have operated similar centers in order to ensure that the call center is up and running quickly. The OCC currently operates a consumer

grounds that such scores are “a judgment call” and could have a “distortional effect” on banks’ operations. Bank examiners have also opposed releasing the scores on the grounds that doing so would make their job more difficult as banks fought for higher scores, which would make exams more hostile. Blackwell, *supra* note 387.

Proponents of disclosing the CAMELS ratings argue that it would force regulators to be more responsible in determining the ratings and that it would provide investors and depositors with greater information about the bank. Blackwell, *supra* note 389; Nader, *supra* note 279.

complaint center in Houston, Texas, which is used to handle complaints about national banks. The center has 40 staff members that respond to approximately 78,000 complaints annually.³⁹² The center returned about \$6 million in fees to consumers in 2002.³⁹³

None of the other options proposed by the GAO would create a single place to which consumers could direct complaints or concerns about financial institutions. The financial conglomerate agency option would add to consumers' confusion by heaping yet another agency on top of more than 115 existing agencies. The functional consolidation option would provide a more viable alternative, but would still not be as effective as the US FSA. Under this alternative, three agencies would be created to which consumers could complain, but consumers may still be confused about whether to raise a complaint concerning insurance or securities sold by a bank to the banking regulator, the securities regulator or the insurance regulator. The twin peaks option would also be better than the existing regime but not as effective as the US FSA, because consumers and investors may still be uncertain as to what concerns or issues to raise with the agency focusing on security issues and those to raise with the agency focusing on conduct-of-business issues. Under the US FSA, consumers and investors would not be faced with this confusing problem.

F. *US FSA Would Provide More Cost Efficient Regulation.*

US FSA would eliminate regulatory overlap and duplication as well as inter-agency turf wars, in which the agencies frequently engage. Additionally, the US FSA would allow more resources, in the form of both funds and personnel, to be used in determining the proper scope and type of regulations to apply.

Through this system, costs would be reduced in several ways. First, money would not be wasted on duplicative efforts in the form of licensing reviews of the same broker or company by different state and federal agencies, on product approvals for the same product by different state and federal agencies, or on examinations by different agencies. Second, economies of scale would allow the US FSA to perform the same functions with fewer employees than the combined workforce currently employed by the state and federal agencies at issue. The US FSA could also reassign agency officials to where the needs are the greatest more readily than could individual smaller agencies. Internal services common to all state and federal agencies – such as human resources, purchasing and accounting – would also

³⁹² Blackwell, *supra* note 387.

³⁹³ *Id.*

realize savings through economies of scale and reduction of the duplication of efforts.³⁹⁴

To varying degrees, other nations and some U.S. states have benefited from these types of cost savings. For example, the UK FSA spent less, in real terms, between 1998 and 2002 than the combined budgets of its predecessor regulatory bodies.³⁹⁵ The UK FSA's budget decreased in real terms during this period, despite the fact that it incurred transitional costs connected with the consolidation of its financial service regulators.³⁹⁶ In addition, by combining its three major financial regulators, Germany was able to reduce its annual expenses by about 4% from 95.4 million in 2001 to 91.6 million in 2003.³⁹⁷ If one factors in inflation, this savings increases to over 8%. Here in the United States, from 2003 to 2004, the State of Illinois was able to reduce the costs it faced in regulating financial services over 14% by consolidating its separate banking, securities and insurance regulators into the Department of Financial and Professional Regulation.³⁹⁸ While Michigan's regulatory expenses increased initially in 2001 and 2002 after the creation of a single financial services regulatory agency, these costs decreased substantially in 2003.³⁹⁹ In that year, Michigan spent 14% less than it spent in 1999 on the regulation of its financial services.⁴⁰⁰

³⁹⁴ CAL. PERFORMANCE REVIEW COMM'N, *supra* note 373. The report cited the consolidation of internal services to achieve economies of scale as a major benefit of its proposal to dramatically consolidate the number of California departments, agencies and boards.

³⁹⁵ 2001-2002 FSA PLAN & BUDGET 45, available at http://www.fsa.gov.uk/pubs/plan/pb2001_02.pdf; Clive Briault, *Revisiting the Rationale for a Single National Financial Services Regulator*, 16 FSA OCCASIONAL PAPER SERIES 16 (2002), available at <http://www.fsa.gov.uk/pubs/occpapers/OP16.pdf>.

³⁹⁶ *Id.*

³⁹⁷ 2003 BUNDESANSTALT FÜR FINANZDIENSTLEISTUNGSAUFSICHT [BAFIN], ANN. REP. Pt. A, at 217 (F.R.G.), available at http://www.bafin.de/jahresbericht/jb03_en.pdf; BUNDESAUFSICHTSAMT FÜR DEN WERTPAPIERHANDEL [BAWE], ANN. REP. 53, available at http://www.bafin.de/jahresbericht/jb01_wa.pdf; 2001 BUNDESAUFSICHTSAMTES FÜR DAS KREDITWESEN [BAKRED] BUS. REP. 70, available at http://www.bafin.de/jahresbericht/jb_ba.pdf; 2001 BUNDESAUFSICHTSAMTES FÜR DAS VERSICHERUNGSWESEN [BAV] BUS. REP. pt. A., at 91, available at http://www.bafin.de/jahresbericht/jb01_va.pdf.

³⁹⁸ Press Release, Ill. Gov't News Network, Five-Agency Merger Will Net \$14 Million in Savings (Feb. 18, 2004), available at <http://www.illinois.gov/PressReleases/ShowPressRelease.cfm?SubjectID=1&RecNum=2740>.

³⁹⁹ 2002 MICH. OFFICE FIN. & INS. SERVICES, ANN. REP. 11, available at http://www.michigan.gov/documents/cis_ofis_ar2002_full_69385_7.pdf; 2001 MICH. OFFICE FIN. & INS. SERVICES, ANN. REP. 10, available at http://www.michigan.gov/documents/cis_ofis_ar2001_full_49006_7.pdf.

⁴⁰⁰ 1999 MICH. FIN. INST. BUREAU, ANN. REP. 55, available at http://www.michigan.gov/documents/cis_ofis_99full_25266_7.pdf; 1999 MICH. INS. BUREAU, ANN. REP. 25, available at http://www.michigan.gov/documents/cis_ofis_99_asr_25455_7.pdf; 2003 MICH. OFFICE FIN. & INS. SERVICES, ANN. REP. 11, available at http://www.michigan.gov/documents/2003_Final_with_bookmarks_97123_7.pdf.

The United States might expect that its savings would mirror or exceed those realized by Illinois and Michigan rather than those of the United Kingdom or Germany, as the United States' regulatory regime is considerably more costly than are those of the United Kingdom and Germany. As previously noted, the United States spends 12 times more than the United Kingdom and over 86 times more than Germany in its regulation of financial services.⁴⁰¹ While some of these costs may be due to the more intensive regulation of financial services undertaken by the United States, some of these costs can be attributed to the jurisdictional overlap between state and federal agencies. These regulatory costs have a ripple effect upon the financial services industry as the fees, assessments, and taxes raised that are used to pay for the regulatory regimes generally far exceed the actual budgets of the regulatory agencies. In the end, financial service customers bear the brunt of these expenses.

These cost savings would not occur in the financial conglomerate agency option. In fact, costs would probably increase as a new agency would be created while all of the other agencies continued to operate. The functional consolidation and twin peaks options would result in some of the cost savings seen in the US FSA model, but would not realize the economies of scale achieved by the US FSA. For example, the three agencies formed under the functional consolidation option or the two agencies formed under the twin peaks option would not be able to reallocate staff to needed areas to the extent that the US FSA could.

VI. POTENTIAL PROBLEMS POSED BY A SINGLE FINANCIAL REGULATOR

Creating a single financial services regulator may pose the following problems:

- Any regulatory consolidation may reduce regulatory competition and experimentation;
- A single regulator would be very large and could prove unwieldy and costly;
- A single regulator may have difficulty prioritizing issues;
- A single regulator may have difficulty responding to smaller firms and, thus, may undermine the diversity of institutions that currently comprise the U.S. financial industry;

⁴⁰¹ See discussion *supra* Part III.F.

- A single regulator may lose or fail to develop staff with specialized knowledge related to large companies, small companies and industry sectors;
- A single regulator may lack accountability to both consumers and market participants; and
- A single regulator will face logistical problems when it merges the existing regulators to form a single agency.⁴⁰²

All of these problems can either be avoided or managed to reduce any negative effects. None of the issues are so grave and intractable as to prevent the creation of a single regulator. Each of these problems will be analyzed in turn.

A. US FSA Would Lose the Benefits of Regulatory Competition.

As discussed in Part III (E), a determination as to whether regulatory competition exists and is desirable has been the focus of much debate.⁴⁰³ Nevertheless, the reduction in regulatory competition from the creation of the US FSA will not result in significant harm, but will actually bring about many benefits.

1. US FSA MAINTAINS THE PROVEN BENEFICIAL ASPECTS OF REGULATORY COMPETITION WHILE ELIMINATING THE MORE PROBLEMATIC ONES.

Supporters of the dual system of state and federal regulation have pointed to the recent activities of New York Attorney General Eliot Spitzer as evidence that states will act when the federal government fails to do so.

⁴⁰² GAO FINANCIAL REGULATION REPORT, *supra* note 8, at 130-31; Martinez & Rose, *supra* note 372, at 27-31.

⁴⁰³ Regulatory competition may take several forms. Regulatory competition may occur in the area of enacting new laws or regulations as well as in the enforcement of existing laws. Articles that support the desirability of regulatory competition include the following, among others: BAIR REPORT, *supra* note 23, at 51; Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998); Rosen, *supra* note 295, at 967 (specialization among regulators allows banks the ability to improve performance by switching regulators).

Arguments supporting the view that regulatory competition either does not exist or is undesirable can be found in the following articles, among others: Butler & Macey, *supra* note 312, at 677 (arguing that regulatory competition in banking does not exist because of the Supremacy Clause); James D. Cox, *Regulatory Duopoly in U.S. Securities Markets*, 99 COLUM. L. REV. 1200, 1201 (1999) (arguing that regulatory competition naturally leads to a "race to the bottom"); Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1338-39 (1999) (arguing that competitive federalism will decrease U.S. economic welfare); Whalen, *supra* note 300.

Spitzer has used New York's Martin Act to bring anti-fraud actions against Merrill Lynch, Salomon Smith Barney and other investment banks for allowing their stock analysts to fraudulently promote stocks. He has also filed suit against mutual funds for allowing certain large clients to engage in late trading and market timing practices to the detriment of small investors, and against hedge funds.⁴⁰⁴ Critics of the SEC claim that the agency failed to bring these cases because it was captured by the industry.⁴⁰⁵

Spitzer's actions, however, fall into two categories: Enforcing existing laws and creating new remedies. With regard to his enforcement actions, several factors are worth mentioning. First, nothing in my proposal would prevent Spitzer or any other state prosecutor from using their office to enforce the federal finance laws. So under the US FSA, the United States will continue to reap the benefits of state enforcement of the financial laws and regulations. Second, as admirable as they may be, Spitzer's actions pose somewhat of an anomaly. For over 70 years prior to Spitzer's appointment to the position, New York attorneys general did not aggressively use the Martin Act to prosecute fraud within the financial services industry.⁴⁰⁶ Spitzer's use of the Martin Act has been criticized as political opportunism rather than as a concerted effort to have New York State remain an effective securities regulator.⁴⁰⁷ Further, Spitzer's actions are not necessarily representative of all state securities regulators. Enforcement actions by state securities regulators have varied considerably from one state to another.⁴⁰⁸ In addition, state budget constraints have resulted in the understaffing of some state banking, securities and insurance staffs, making it more difficult these entities to operate as effective regulators.⁴⁰⁹

With respect to the remedies sought by Spitzer, these actions are not as beneficial as his supporters contend and frequently seem to have little relation to the harms incurred. In the case of his actions against the mutual fund industry, he required the funds to reduce their fees as part of

⁴⁰⁴ Nicholas Thompson, *The Sword of Spitzer*, LEGAL AFFAIRS, at 53-54 (2004).

⁴⁰⁵ *Id.* at 54 (stating that Noreen Harrington, the whistleblower who tipped off Spitzer's office to the problems in the mutual fund industry, did not approach the SEC because she did not believe the SEC would act on her tip).

⁴⁰⁶ *Id.* at 51-52 (noting that the Martin Act was generally not used by the New York attorney generals for over 70 years during the period from the end of Attorney General Albert Ottinger's term in 1928 until 2001 when Attorney General Eliot Spitzer decided to use the Martin Act against Merrill Lynch).

⁴⁰⁷ *Id.* at 54 (commenting that Spitzer has raised a significant amount of money for future races and quoting at least one critic who says that Spitzer "will screw you for everything he can to get publicity").

⁴⁰⁸ Joel Seligman, *Multiple Regulators: Where Are We? How did We Get Here?*, THE FINANCIAL SERVICES REVOLUTION, at 471 (Clifford E. Kirsh, ed. 1997).

⁴⁰⁹ Thompson, *supra* note 404, at 54 (2004).

settlements even though the high fees charged by funds had little or no relation to the market timing and late trading practices for which Spitzer had sought legal redress.⁴¹⁰

It is, in fact, the regulators in all 50 states that impose duplicative or inconsistent regulations that are at the root of the current structure's problem. Spitzer himself admitted in a speech to the alumni of New York University School of Law that allowing all 50 states to regulate financial services is problematic. At the same time, he expressed his hope that Congress would not preempt state actions during over the course of the following three years, the remainder of his term as Attorney General.⁴¹¹

2. PROPONENTS OF REGULATORY COMPETITION HAVE EXAGGERATED HOW FREQUENTLY IT OCCURS.

The current regime does not provide many concrete examples of true regulatory competition. The case supporting this proposition was well articulated by Henry N. Butler and Jonathan R. Macey in their article, "The Myth of Competition in the Dual Banking System."⁴¹² There, they argue that the dual banking system does not really lead to regulatory competition because of several factors, including: (1) the federal government exercising its powers of preemption under the power of the Supremacy Clause to prevent any significant loss of market share or regulatory control to the states; (2) requiring both state and federal banks to obtain FDIC insurance in order to remain competitive and subjecting them to the regulations set forth by the FDIC; and (3) 34 states adopting laws that automatically impose the regulations of national banks on state banks in certain circumstances.⁴¹³ Butler and Macey also concluded that it was in the best interests of both state and federal bank regulators to engage in cooperative practices rather than in competition to enhance their relative power and to extract the maximum rents from the banking industry.⁴¹⁴ They then went on to characterize the existing system of state and federal bank regulators as a regulatory cartel.⁴¹⁵

A similar case has been made in the context of insurance. Proponents of the existing system have argued that currently, regulators are allowed to experiment with different regulatory frameworks. These individuals argue that this experimentation results in the formulation of effective regulations which then lead an adoption of the best practices at the state level. In reality,

⁴¹⁰ *Id.*

⁴¹¹ *Id.* (in the same speech, Spitzer noted, "In three more years, I'll move on to other things.")

⁴¹² Butler & Macey, *supra* note 312.

⁴¹³ *Id.* at 694-99; ANN GRAHAM, BANKING LAW § 4.03[10] (LexisNexis Matthew Bender: 2004).

⁴¹⁴ Butler & Macey, *supra* note 312, at 691-93.

⁴¹⁵ *Id.* at 690.

this type of regulatory competition rarely occurs.⁴¹⁶ For example, in the case of regulations governing insurance receiverships, a lack of uniformity in how states establish, operate and evaluate property-liability insurance receiverships certainly exists, which theoretically should lead to this type of regulatory competition.⁴¹⁷ These types of regulation, however, generally garner little attention from either the states' executive or legislative branches. This is surprising as current regulations generally result in significantly greater losses for government sponsored guaranty associations from property-liability failures than for other financial institutions.⁴¹⁸

According to a recent empirical study, the average cost to guaranty associations for property-liability insurers' insolvencies during the period from 1986 to 1999 was \$1.10 per \$1 of pre-insolvency assets, which is three to five times as much as the losses realized by a typical bank failure.⁴¹⁹ The study determined that one of the main factors causing the high cost of insurance insolvency resolution was regulatory forbearance and that earlier intervention by regulators before an insurer actually becomes insolvent or generates large deficits would result in significant cost savings.⁴²⁰ Calls for reform, however, have occurred in only a few states. Between 1986 and 2000, three states produced auditor general reports on their state insurance receivership practices. Each of these reports was highly critical of the existing departmental practices and called for reform. Nevertheless, none of these states instituted major structural reforms.⁴²¹

3. THE BENEFITS OF REGULATORY COMPETITION HAVE NOT PERSUADED OTHER COUNTRIES TO RECREATE THE MULTITUDE OF REGULATORS IN THE UNITED STATES.

Over the past 20 years, at least 50 countries have either created a single financial services regulator or a semi-integrated regulatory structure for financial services by consolidating the regulation of at least two sectors, either: banking and securities, banking and insurance, or securities and

⁴¹⁶ Martin F. Grace et al., *Insurance Company Failures: Why Do They Cost So Much?*, at 31 (Ga. St. Univ. Ctr. for Risk Mgmt. & Ins. Research, Working Paper No. 03-1, 2003).

⁴¹⁷ *Id.*

⁴¹⁸ *Id.*

⁴¹⁹ *Id.* at 2 (citing an empirical study by Christopher James published in 1991 that found that the average cost of the typical bank failure in the late 1980's was \$0.30 per \$1 of pre-insolvency assets and another empirical study by George G. Kaufmann published in 2001 that found that the average cost of the typical bank failure in the period 1995-2000 was \$0.20 per \$1 of pre-insolvency assets).

⁴²⁰ *Id.* at 29, 31.

⁴²¹ Grace, *supra* note 416, at 31.

insurance, into one agency.⁴²² While some of the countries that have created an integrated financial service regulatory agency are quite small, others – like the United Kingdom, Japan and Germany – have large and sophisticated financial systems. Japan, Germany and the U.K. made up three of the four leading insurance countries in 2001 in terms of direct premiums written.⁴²³ These countries also contain three of the largest securities markets in the world: The Nikkei, Deutsche Borse, and the London Stock Exchange. Furthermore, Japanese, German and British banks are some of the largest banks in the world. The following table lists all of the countries that have single financial regulators or semi-integrated regulators:

⁴²² A number of articles have compared the supervisory regimes of different countries adopting a single banking or financial services supervisory agency model, including: Richard K. Abrams & Michael W. Taylor, *Issues in the Unification of Financial Sector Supervision* (IMF, Working Paper No. WP/00/213, Dec. 2003); James R. Barth et al., *A Cross-Country Analysis of Bank Supervisory Framework and Bank Performance*, 12 FIN. MARKETS, INST. & INSTRUMENTS 67 (May 2003); Ellis Ferran, *Symposium: Do Financial Supermarkets Need Super Regulators? Examining the United Kingdom's Experience in Adopting the Single Financial Regulator Model*, 28 BROOK. J. INT'L L. 257 (2003); Markham, *Super Regulator*, *supra* note 351, at 319; Martínez & Rose, *supra* note 372; Marc Quintyn & Michael W. Taylor, *Regulatory and Supervisory Independence and Financial Stability* (IMF, Working Paper No. WP/02/46, March 2002); 2001 HUNG. FIN. SUPERVISORY AUTH., ANN. REP. 3 (May 2002); 2003 CENT. BANK & FIN. SERV. AUTH. OF IR. ACT NO. 12. The GDP of these countries in 2002 totaled approximately \$15.35 trillion, or 31.3 percent of the world's GDP. CENT. INTELLIGENCE AGENCY, *THE WORLD FACTBOOK, Rank Order – GDP*, available at www.cia.gov/cia/publications/factbook/rankorder/2001rank.html.

⁴²³ INS. INFO. INST., *INTERNATIONAL INS. FACT BOOK 2003*, available at www.internationalinsurance.org/international/overview/.

Countries with Either an Integrated or Semi-Integrated Financial Services Agency as of January 1, 2006.⁴²⁴

Single Supervisor for Financial Services (Year Created)	Single Agency Supervising Two Types of Financial Intermediaries		
	Banks and Securities Firms	Banks and Insurers	Securities Firms and Insurers
Austria (2002) Bahrain (2002) Cayman Islands (1997) Denmark (1988) Estonia (2002) Germany (2002) Gibraltar (1991) Hungary (2000) Iceland (2001) Ireland (2003) Japan (2000) Kazakhstan (2004) Latvia (2001) Maldives (1999) Malta (2002) Nicaragua Norway (1986) Singapore (1984) South Korea (1998) Sweden (1991) Taiwan (2004) UAE UK (1997)	Dominican Republic Finland Luxembourg Mexico Switzerland Uruguay	Australia Belgium Canada Colombia Ecuador El Salvador Guatemala Kazakhstan Malaysia Peru Saudi Arabia Venezuela	Bolivia Bulgaria Chile Egypt Jamaica Mauritius Slovakia South Africa Ukraine

⁴²⁴ Martínez & Rose, *supra* note 372, at 13; Barth et al., *supra* note 422; 2003 CENT. BANK & FIN. SERVICES AUTH. OF IR. ACT No. 12, *supra* note 422, at Part III.A., Ch. I, par. 33B (2003); Bahrain Monetary Agency, *Financial Sector Overview*, available at <http://www.bma.gov.bh/cmsrule/index.jsp?action=article&ID=16>; Bulgaria Financial Supervision Commission, *About the Commission*, available at www.scbg/e_fsc_page.asp?v=2; Cayman Island Monetary Authority, *About Us—Some Events in the History of the Cayman Islands*, available at www.cimoney.com.ky/templates/HTMLPage/defaultdisplay.asp?text_id=HTMLPage50644&button=1; *Dominica to Set Up a Single Financial Regulatory Body*, FIN. TIMES (Dec. 31, 2003); Finland Ministry of Finance, *Stability and Supervision*, available at www.vm.fi/vm/liston/print.jsp?r=2702&l=en; Gibraltar Financial Services Commission, *About Us – Commission*, available at www.fscgi/fsc/commission.htm; Financial Services Commission of Jamaica, *Brief History*, available at www.fscjamaica.org/public_info_files/page0013.htm; Gulmira Kapenova, *Supervision of the Securities Market in Kazakhstan*, available at www.oecd.org/dataoecd/14/30/31739306.pdf; SAUDI ARABIA MONETARY AGENCY, *A Case Study on Globalization and the Role of Institution Building in the Financial Sector in Saudi Arabia*, at 12, Feb. 2004, available at <http://www.sama-ksa.org/en/news/2004-03/SK521>; Taiwan Combining Financial Regulators to Bring in Investors, TAIWAN NEWS, July 1, 2004; Franco van Zyl, *Financial Regulation Lagging*, SUNDAY BUS. TIMES, available at www.btimes.co.za/98/0329/btmoney/money17.htm.

Several other countries are either considering or already have considered creating a single financial supervisor. Countries considering the creation of a single financial supervisory agency include Russia, Bulgaria, Indonesia, Italy, Mexico, Philippines, Poland, Slovakia, Slovenia, South Africa, the Ukraine⁴²⁵ and Finland.⁴²⁶ Some countries, like the Netherlands and Australia, have moved from having at least one separate regulator for banks, securities firms, and insurers, to consolidating at least two of these regulators into one agency.⁴²⁷

The actions of these nations illustrate that the international trend has been toward the consolidation of financial supervision and regulation into fewer agencies, even though the countries that have elected to establish a single financial services regulator have not uniformly agreed what powers should be bestowed upon this agency.⁴²⁸ This suggests that, in the marketplace of ideas, other nations are not convinced that the benefits of regulatory competition outweigh its considerable costs.

B. US FSA Would be Large and Unwieldy.

The GAO commented that a single financial regulator for the United States would have to be considerably larger than those existing in other countries, like the UK FSA in the United Kingdom.⁴²⁹ The GAO noted that the UK FSA only had 2,300 employees while the total number of employees in the existing state and federal regulators in the United States is significantly larger, ranging from about 30,000 to 40,000.⁴³⁰ The US FSA would probably

⁴²⁵ Martínez & Rose, *supra* note 372, at 4; Honey Madrilejos-Reyes, *Senate Proposes Single Financial Regulation*, MANILA TIMES, June 17, 2003.

⁴²⁶ On Nov. 24, 1997, a report commissioned by the Finnish Ministry of Finance was published, which recommended that the Insurance Supervision and the Financial Supervision Authority be merged into a single regulatory authority in the Prime Minister's Office. Kaario Jännäri, *Means, Strategies and Internationalization of Financial Supervision*, FINNISH FIN. SUPERVISION AUTH. BULLETIN 1, 7 (1998), available at www.rahoitustarkastus.fi/english/publications/data/speeches_and_articles/1jannari.pdf.

⁴²⁷ The Netherlands is in the process of adopting a twin peaks regulatory model, while Australia adopted a twin peaks approach in 1998. THE GAO FINANCIAL REGULATION REPORT, *supra* note 8, at 70-71.

⁴²⁸ For example, some nations exclude certain financial intermediaries from regulation and supervision by the integrated agencies. The United Kingdom initially did not grant the UK FSA the power to regulate mortgage advisers and insurance brokers, although both groups became subject to regulation by the UK FSA in 2004. Latvia and Singapore have not subjected leasing companies to regulation by their respective integrated financial service regulators. Martínez & Rose, *supra* note 372, at 13.

⁴²⁹ GAO FINANCIAL REGULATION REPORT, *supra* note 8, at 131.

⁴³⁰ *Id.*

retain fewer people than currently are employed by all of the existing U.S. financial regulators, as it would eliminate duplicative requirements and administrative bodies. When Germany consolidated its banking, securities, and insurance regulatory agencies between 2001 and 2003 to create its single regulator, BaFin, it reduced the number of staff employed by the financial regulators by about 20%.⁴³¹ Even if the US FSA did not achieve the dramatic reduction in staff that Germany's BaFin achieved, 40,000 people working together would be more productive than they are in the current system, as the number of regulatory turf wars would be greatly reduced.

Certainly the process of creating such a large agency will include a large number of political obstacles. Nevertheless, even if the US FSA retained all of the roughly 40,000 employees in the existing state and federal financial regulators, the US FSA would not be the largest federal government agency, nor would it even make the list of one of the ten largest federal departments or agencies.⁴³² The US FSA, in fact, would be over 33% smaller than the average federal cabinet department, excluding the Department of Defense, the Department of Veterans Affairs, and the Department of Homeland Security.⁴³³

⁴³¹ The number of staff for the German federal banking, securities and insurance regulators in 2001 totaled 1,133 and the number of staff for BaFin in 2003 totaled 901. 2001-2002 FIN. SERVICES AUTH. [FSA] ANN. REP. 72 (U.K.), *supra* note 361, at 80; UK FSA, ANN. REP., *supra* note 336, at 205.

⁴³² The top ten federal agencies and departments in descending order are: the Department of Defense, the Department of Veterans Administration, the Department of Homeland Security, the Department of the Treasury, the Department of Agriculture, the Department of Justice, the Department of the Interior, the Department of Health and Human Resources, the Department of Transportation, and the Social Security Administration. OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOV'T, FISCAL YEAR 2005, *available at* www.whitehouse.gov/omb/budget/fy2005.

⁴³³ OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOVE'T, DEP'T OF THE TREASURY, FISCAL YEAR 2005, *available at* www.whitehouse.gov/omb/budget/fy2005/treasury.html; OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOV'T, DEP'T OF COM., FISCAL YEAR 2005, *available at* www.whitehouse.gov/omb/budget/fy2005/commerce.html; OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOV'T, DEP'T OF STATE, FISCAL YEAR 2005, *available at* www.whitehouse.gov/omb/budget/fy2005/state.html; OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOV'T, DEP'T OF HOUS. AND URBAN DEV., FISCAL YEAR 2005, *available at* www.whitehouse.gov/omb/budget/fy2005/hud.html; OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOV'T, DEP'T OF EDUC., FISCAL YEAR 2005, *available at* www.whitehouse.gov/omb/budget/fy2005/education.html; OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOV'T, DEP'T OF AGRIC., FISCAL YEAR 2005, *available at* www.whitehouse.gov/omb/budget/fy2005/agriculture.html; OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOV'T, DEP'T OF JUSTICE, FISCAL YEAR 2005, *available at* www.whitehouse.gov/omb/budget/fy2005/justice.html; OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOV'T, DEP'T OF LABOR,

The merger of the existing state and federal regulators into the US FSA would not be the largest merger of government agencies, in terms of number of employees, ever undertaken by the United States. The creation of the Department of Homeland Security, which has over 183,000 employees, represented a considerably larger merger than would be the US FSA merger in terms of number of employees.⁴³⁴ The Department of Homeland Security has roughly 4½ times the total number of employees currently making up the workforce of all of the federal and state financial regulatory agencies combined.⁴³⁵

Certainly Congress would more likely be motivated to create a large financial regulator, like the US FSA, if the United States experienced a major financial crisis. Prior to terrorist attacks of September 11, 2001, few in the United States would have foreseen the creation of the Department of Homeland Security. However, following the attacks, there was sufficient

FISCAL YEAR 2005, available at www.whitehouse.gov/omb/budget/fy2005/labor.html; OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOV'T, DEP'T OF TRANSP., FISCAL YEAR 2005, available at www.whitehouse.gov/omb/budget/fy2005/transportation.html; OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOV'T, DEP'T OF ENERGY, FISCAL YEAR 2005, available at www.whitehouse.gov/omb/budget/fy2005/energy.html; OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOV'T, DEP'T OF HEALTH AND HUM. RES., FISCAL YEAR 2005, available at www.whitehouse.gov/omb/budget/fy2005/health.html; OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOV'T, DEP'T OF INTERIOR, FISCAL YEAR 2005, available at www.whitehouse.gov/omb/budget/fy2005/interior.html; OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOV'T, DEP'T OF DEFENSE, FISCAL YEAR 2005, available at www.whitehouse.gov/omb/budget/fy2005/defense.html; OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOV'T, DEP'T OF HOMELAND SEC., FISCAL YEAR 2005, available at www.whitehouse.gov/omb/budget/fy2005/homeland.html; OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOV'T, Dept of Veterans Affairs, FISCAL YEAR 2005, at www.whitehouse.gov/omb/budget/fy2005/veteransaffairs.html. The Department of Defense, which is the largest federal government agency, has about 700,000 civilian employees in addition to the 2.3 million military personnel in the active military, reserves and national guard, the Department of Veterans Affairs employs 211,764 people, and the Department of Homeland Security employs over 183,000 people. OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOV'T, DEP'T OF DEFENSE, FISCAL YEAR 2005, available at www.whitehouse.gov/omb/budget/fy2005/defense.html; OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOV'T, DEP'T OF HOMELAND SEC., FISCAL YEAR 2005, available at www.whitehouse.gov/omb/budget/fy2005/homeland.html; OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOV'T, DEP'T OF VETERANS AFFAIRS, FISCAL YEAR 2005, available at www.whitehouse.gov/omb/budget/fy2005/veteransaffairs.html.

⁴³⁴ OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOV'T, DEP'T OF HOMELAND SEC., FISCAL YEAR 2005, *supra* note 430.

⁴³⁵ *Id.*

political momentum to rapidly push legislation creating this department through Congress. It is possible that some future financial crisis will help build a political coalition desiring the creation of the US FSA. Financial crises in the Nordic countries and in the United Kingdom provided significant momentum to create single financial regulators.

C. US FSA May Have Difficulty Prioritizing Issues.

The charge that the US FSA would have difficulty prioritizing issues is unfounded. This criticism could be leveled at any organization and does not appear to be a unique feature of a single regulator. The UK FSA has benefited from the clear goals enunciated in its enabling legislation, which have helped it prioritize the issues that it confronts. Congress could minimize or eliminate this problem if it also provided a clear set of goals when establishing the US FSA.

D. US FSA May be Unresponsive to Small Firms.

This problem could be raised with respect to any consolidation of regulators. Merely increasing the size of an organization does not mean that it will automatically begin ignoring small financial firms and individuals. The accountability safeguards, such as the practitioners' panel and the consumers' panel, would help mitigate any tendency on the part of the US FSA to do so, as these panels would force the US FSA to account for such actions. If this is truly a realistic concern, a separate small business panel could be created that would ensure that the US FSA appropriately addresses the unique concerns of small business.

E. US FSA May Fail to Develop Staff With Specialized Knowledge Concerning Sectors Within the Financial Services Industry.

Again this problem can be eliminated in the way the US FSA is organized. Under my proposal described in Part IV, the Prudential Division and the Regulatory Processes and Risk Division would contain groups that deal with diversified firms and other groups that would deal with specialized financial firms. Under the proposed structure, the US FSA would be developing and employing staff that would not only retain but build upon the specialized knowledge pertaining to certain sectors and businesses.

F. *US FSA May Lack Accountability.*

How the regulator is structured will determine its level of accountability. In Part IV, I proposed several features that would enable Congress, practitioners and consumers to hold the US FSA accountable for its actions. These features include the practitioners' and consumers' panels and both annual and periodic reports to Congress, as well as the possibility of the creation of a special office which would investigate complaints against the US FSA. All of these features would assist in holding the agency accountable for its regulation and supervision of the financial industry.

G. *US FSA May Experience Logistical Problems When it Merges the Multiple Regulators.*

The US FSA may encounter the following logistical problems when it merges the existing regulators to form the new agency:

- Legal constraints requiring the passage of several pieces of financial sector legislation during the first three years of existence;
- Loss of experienced personnel;
- Delays in integrating information technology systems and the infrastructure of merged agencies;
- Demoralization of the staff of the merged entities;
- Lack of mission and clarity in the newly merged institution;
- Budgetary problems, which will result in an insufficiency of funds to complete the integration of agencies;
- One approach to supervision dominating the others, occurring particularly when one agency, usually the banking regulator, has more staff, resources and facilities prior to the merger of the agencies;
- Market confusion arising if efforts are not made to make certain that all market participants understand the reasons for creating an integrated agency; and
- Integrating agencies when the financial sector is experiencing a crisis may prevent management from focusing on important supervisory tasks and, thus, creating an integrated financial services agency should be done when the financial system is stable.⁴³⁶

In creating the US FSA, I recognize that the United States would face several legal constraints that would require the passage of major amendments

⁴³⁶ Martinez & Rose, *supra* note 372, at 27-31.

to existing legislation. The burden of doing so, however, could be mitigated if Congress would be willing to pass a single bill containing all of the necessary changes. This is how the UK created the UK FSA, and, subsequently, was able to avoid some of the problems faced by other countries choosing to enact multiple pieces of legislation.

The United States would almost certainly face the problem of loss of personnel. Nine out of the 14 countries surveyed by Martinez and Rose reported losing experienced personnel following the integration of their agencies. Eight of the 14 countries reported that the staffs of the merged entities during and after the integration process were demoralized.⁴³⁷ The reasons for these problems stem from the uncertainty engendered by the merger process, the possibility of layoffs, and the delay in establishing the structure of the unified entity, appointment of the heads of departments, and establishment of the conditions of employment.⁴³⁸ On average, the 14 nations surveyed reported that it took between 0.7 and 0.9 years to appoint the new heads of the departments, to integrate budgetary processes, and to reallocate personnel.⁴³⁹ Once the transition process was complete, however, some nations like the United Kingdom reported that the unified agency was considered to be a more desirable employer than any of the former agencies, making recruitment easier.⁴⁴⁰

The United States would also be likely to experience a problem with the integration of information technology. Eight out of the 14 countries surveyed reported that they experienced delays in integrating the information technology systems and the infrastructure of the former agencies.⁴⁴¹ The 14 nations surveyed reported that it took 1.1 years to integrate the information systems of the merged agencies.⁴⁴² Here in the United States, the Department of Homeland Security had to deal with information technology problems when it merged the 20 existing agencies. Since all of the state and federal regulators do not use the same computer systems, information technology problems are certain to arise. Nevertheless, these problems are transitory and are outweighed by the benefits resulting from the creation of the US FSA.

Only two nations reported other managerial problems, such as budgetary problems or a lack of mission.⁴⁴³ Even so, on average, it took the 14 surveyed nations two years to establish the definitive structure of the integrated

⁴³⁷ *Id.* at 27-28.

⁴³⁸ *Id.* at 28.

⁴³⁹ *Id.* at 30.

⁴⁴⁰ *Id.* at 28.

⁴⁴¹ Martinez & Rose, *supra* note 372, at 27-28.

⁴⁴² *Id.* at 30.

⁴⁴³ *Id.* at 27-28.

agency.⁴⁴⁴ Both of these problems can be addressed by making adequate budgetary appropriations and by incorporating a clear mission statement into the act establishing the US FSA. In addition, by creating a new agency and not merging the other agencies into a dominant agency such as the Federal Reserve, the United States would avoid the problem of one regulatory approach dominating others. The problem of market confusion could also be avoided if the US FSA and its predecessor regulators properly educate the public and market participants about the need for a new regulator.

If the structure proposed in this article is adopted, the US FSA would not suffer from the lack of regulatory and supervisory independence arising in Japan. In effect, the US FSA would be closer to the Federal Reserve in terms of its regulatory and supervisory independence than it would be to Japan's FSA.

Finally, the problem of the management of the new US FSA being unable to focus on important supervisory tasks while trying to integrate the different agencies during a financial crisis could be avoided by Congress through the immediate passage of legislation that would create the US FSA before a major financial crisis occurs.⁴⁴⁵ Unfortunately, history shows that Congress frequently waits for a financial crisis to erupt before choosing to act.

None of the problems raised above pose insurmountable obstacles to the creation of a single financial authority. Careful planning could avoid most of the problems revealed herein. The United States can benefit from the experiences of others when it creates the US FSA through drawing upon the successes and failures encountered thus far in similar transitions.

VII. CONCLUSION

The United States would greatly benefit from consolidating its existing financial regulatory organizations into a single agency. The optimal number of agencies regulating the financial services industry in the United States is certainly less than the over 115 agencies currently in place.

As the evidence presented above demonstrates, the optimal number of financial regulators in the United States is one. A single, federal financial regulator would be able to anticipate and plan for future financial crises, more carefully monitor and regulate financial conglomerates, provide better protection for consumers, operate more effectively in international negotiations, quickly adapt to market innovations and developments, be accountable for market failures, eliminate the duplicative regulations and

⁴⁴⁴ *Id.* at 30.

⁴⁴⁵ *Id.* at 31.

regulatory gaps, harmonize regulations for financial products and firms competing in the market, and avoid being captured by narrow segments within the financial services industry. Not only would the US FSA be able to provide all of these benefits, but it could do so at a lower cost than the either current regulatory regime or any of the alternatives proposed by the GAO. The time has come for the United States to overhaul its outdated financial regulatory system and adopt a single financial regulator for the twenty-first century and beyond.

