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

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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 regulate more effectively 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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E Pluribus Unum – Out of Many, One: Why the United States Needs a Single Financial Services Agency

TABLE OF CONTENTS

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

I. INTRODUCTION

The financial services[1] industry within 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, increasingly are 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 conglomerates[4] are

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[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." BANK FOR INTERNATIONAL SETTLEMENTS, BASEL COMMITTEE ON BANKING SUPERVISION, INTERNATIONAL 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). 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.

expanding their shares of 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. regulation[6] 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") and the 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

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[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 BROOKLYN J. INT'L L. 455, 455 (2003) (hereinafter *Address by Peter R. Fisher*) (proposes separating financial rulemaking authority from supervisory authority and placing rulemaking authority into a single, federal regulator while leaving supervisory authority within several agencies).

[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.

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, and that the 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.[8] 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.[9]

In addition, the current 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 UK FSA and 86 times more than the budget of German Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht or BaFin), which is the single financial regulator in Germany.[10] 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 regulate more effectively 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. 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[11] ("GLBA").

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[8] U.S. GOVERNMENT ACCOUNTABILITY OFFICE, REPORT TO THE CHAIRMAN, COMMITTEE 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] See text of Part V, F. US FSA Would Provide More Cost Efficient Regulation and accompanying notes *infra*.

[11] PUB. L. NO. 106-102, §1, 107 Stat. 1338 (1999) (codified at scattered sections of 12, 15, 16, 18 U.S.C.).

GLBA repealed portions of the Glass-Steagall Act of 1933[12], the Bank Holding Company Act of 1956[13] 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, which would enable them to cross sell each other's products and services.[14] 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 issued by the existing state and federal financial service regulatory agencies.[15] GLBA preserved all of the existing federal and state regulators while making minor adjustments to their regulatory responsibilities.[16] As a result, 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."[17] The GAO suggested that Congress consider adopting one of the following four options to address the problems in the current system:

- Consolidate 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 that would focus on different objectives, one agency focusing on the safety and soundness of the financial system and the entities within it and the other agency focusing on conduct-of-business issues, such as consumer and investor

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[12] 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)(2004).

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

[14] GLBA, §101, 12 U.S.C.S. §377 and §78 (2004).

[15] 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 *infra.* Part II.

[16] See *infra.* Part II.

[17] GAO FINANCIAL REGULATION REPORT *supra.* note 8 at 19.

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 retaining all of the other existing financial regulators (hereinafter referred to as the "financial conglomerate agency option").[18]

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.[19] 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.[20]

Nevertheless, the creation of a US FSA would, in fact, be the best solution to the challenges facing the U.S. financial regulatory regime. All of the other options presented would allow many of the problems in the existing system to persist. The US FSA would enable the United State 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.[21]

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.

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[18] *Id.* at 19-23.

[19] *Id.*

[20] *Address by Peter R. Fisher, supra.* note 6 at 458 (comments that concentrating power in a single regulatory violates U.S. political tradition); HELEN A. GARTEN, US FINANCIAL REGULATION AND THE LEVEL PLAYING FIELD 135-138 (2001) (describes 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 (June, 1998) (argues that states should play a greater role in securities regulation because of the benefits of regulatory competition).

[21] 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

Part III will discuss the major challenges to the financial services industry that the existing regulatory structure is ill equipped to handle. Part 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.[22] 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 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

[22] 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) (transcript 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 (April, 2000) (hereinafter Markham, *Banking Regulation*); PATRICIA A. MCCOY, 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 (August, 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 (Spring, 1999).

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.[23] 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.[24] 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 direct competitors with banking products.[25] The distinctions between the banking, securities and insurance sectors began to blur because these new financial products were fungible.[26] 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, pressures began to build 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 and not based upon the type of institution providing the product.[27] Under a pure functional regulation scheme, the securities regulators would regulate securities regardless of whether they were sold by banks or by securities firms.[28]

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

[23] McCoy at §12.02[2].
[24] *Id.*
[25] *Id.* at §12.02[1].
[26] *Id.*
[27] *Id.* at §12.02[2].
[28] *Id.*

enacted GLBA. 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 the companies in the insurance, banking and securities sectors from engaging in each other's businesses. As previously noted, GLBA merely ratified the changes that were ongoing in these sectors and that resulted in the convergence of financial products and services.[29] Under GLBA, the regulatory structure preserves some forms of entity regulation by granting regulatory authority to some agencies based on the institution being regulated[30] while in other instances regulatory authority is assigned to an agency based upon the nature or function of the product or service being provided.[31]

1. Banking and Other Depository Institutions Regulatory Agencies

a. Regulation of Financial and Bank Holding Companies:

GLBA permitted banks, securities firms and 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.[32] GLBA designated the Federal Reserve, which supervises bank holding companies, to become the supervisor for the FHCs.[33] 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.[34]

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.[35] A FHC also may 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.[36]

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29 *Id.* at §12.02[1].

30 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 text of Part II, A, 4. Functional Regulation *infra*.

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

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

33 *Id.*

34 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)).

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

36 *Id.*

Only 12 percent of all of the bank holding companies in existence as of March 31, 2003, have elected to become FHCs.[37] 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 GLBA.[38]

Only a few firms that had not previously been affiliated with a commercial bank before the enactment of GLBA, elected to become FHCs.[39] Charles Schwab & Co., MetLife and Franklin Resources fall into this category.[40] Many of the largest financial conglomerates have not registered as FHCs, including American Express, Merrill Lynch, American International Group, and Household International.[41]

Concerns over 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.[42] In addition, they believe that the Federal Reserve lacks the expertise to regulate financial conglomerates with substantial businesses in investment banking and insurance, because the Federal Reserve traditionally only regulated commercial banks.[43]

These financial conglomerates also are particularly concerned that the Federal Reserve is slow to approve new products and services for FHCs, which may put FHCs at a competitive disadvantage to other financial conglomerates.[44]

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[37] 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.*

[38] *Id.* at 3.

[39] *Id.*

[40] *Id.*

[41] Financial Holding Companies as of August 6, 2004, Federal Reserve Board <www.federalreserve.gov/generalinfo/fhc/> (accessed Aug. 12, 2004); THE FINANCIAL SERVICES FACT BOOK *supra.* note 3 at 9. In fact, only two 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/> (accessed Aug. 12, 2004).

[42] 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 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.*

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

[44] 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

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.[45] 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.[46] Nevertheless, the Federal Reserve and the Treasury still had not adopted this regulation as of January 31, 2005.

b. Regulation of Banks:

Whether an agency supervises and regulates a bank depends upon whether the bank 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 OCC and subject to its supervision and regulation.[47] National banks are also required to be members of the Federal Reserve System.[48]

Well-capitalized and well-managed national banks can own financial subsidiaries that sell insurance or securities.[49] 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.[50] In addition, the 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.[51] 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

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After its Passage before the Committee on Banking, Housing and Urban Affairs of the U.S. Senate 6 (July 13, 2004).

[45] Bartlett *supra*. note 42; Doherty, *supra*. note 42.

[46] Doherty, *supra*. note 44.

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

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

[49] GLBA §121(a)(2), 12 U.S.C.S. §§24a(a)(2)(C), 24a(g)(5) & 24a(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. GLBA §121(a)(2), 12 U.S.C.S. §24a(g)(6)(2004).

[50] GLBA §121(a)(2), 12 U.S.C.S. §24a(a)(2)(B) (2004).

[51] GLBA §121(a)(2), 12 U.S.C.S. §24a(e)(4)(2004).

bank that owns securities and insurance company subsidiaries, which is regulated by the OCC.

State banks are chartered by individual states and can choose to either be a member of the Federal Reserve System or not.[52] A state chartered bank will be 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.[53] If the state chartered bank is not a member of the Federal Reserve System, then the FDIC will be its primary federal regulator.[54] The FDIC also acts as a back-up supervisor for other national chartered and state chartered banks, which are insured by the FDIC.[55]

In the years following the enactment of GLBA, the total number of banks in the United States, both nationally chartered and state chartered, has declined.[56] In 2003, nationally chartered banks comprised only a little more than 25 percent of the total number of banks in the United States, but held 55.4 percent of the total deposits in the United States.[57] In addition to holding more deposits than state chartered banks, nationally chartered banks on average were more profitable than state banks in 2003.[58]

c. Regulation of Savings and Loans and Their Holding Companies:

The OTS supervises savings and loan holding companies, which are companies that directly or indirectly control a savings association or thrift.[59] 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.[60] State chartered thrifts are also chartered, supervised and regulated by the state savings and loan commissions that granted

[52] McCoy at §§2.03[a], 3.02.
[53] 12 U.S.C.S. §§248, 325, 338, 483 (2004).
[54] 12 U.S.C.S. §1831a (2004).
[55] 12 U.S.C.S. §§1815 and 1828 (2004).
[56] FDIC, Statistics on Depository Institutions <http://www2.fdic.gov/sdi/index.asp> (May 28, 2004). The total number of nationally chartered banks declined 15.5 percent to 1999 banks in 2003, while the number of state chartered banks declined 7.1 percent to 5,771 banks in 2003. *Id.*
[57] *Id.*
[58] *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. *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. *Id.*
[59] Office of Thrift Supervision, U.S. Department of the Treasury, 2003 Fact Book 72 n. 17 (May 2004) (hereinafter OTS Fact Book).
[60] 12 U.S.C.S. §1463 (2004).

them their charters. The FDIC also acts as a back-up regulator for thrifts that are insured by SAIF.[61]

In 2003, nationally chartered savings and loans comprised 87.8 percent of all of the savings associations in the United States.[62] In addition, the savings and loan holding companies own over half of the savings associations in the United States in 2003.[63] Thrifts on average are as profitable as state banks, although they hold fewer assets than national and state banks.[64] In 2003, thrifts held assets equal to about 20 percent of the assets held by national and state banks.[65]

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").[66] The NCUA also contains the National Credit Union Share Insurance Fund ("NCUSIF"), which insures deposits within credit unions.[67]

Credit unions cannot serve the general public but 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.[68] 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.[69]

2. Insurance Regulatory Agencies

Unlike depository institutions, which are regulated by both the federal and state governments, insurance is regulated almost exclusively by the state insurance commissions. The state insurance commissions regulate insurance

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[61] 12 U.S.C.S. §§1814-1816 (2004).

[62] OTS FACT BOOK, *supra.* note 59, at 2. The United States had 928 savings associations in 2003, of which 815 had national charters. *Id.*

[63] *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.

[64] Conference of State Bank Supervisors, Number of Commercial Banks by Charter <www.csbs.org/info_stats/banks_by_charter.htm> (Aug. 28, 2003); 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.*

[65] THE FINANCIAL SERVICES FACT BOOK *supra.* note 3 at 71.

[66] 12 U.S.C.S. §1752 (2004).

[67] 12 U.S.C.S. §1783 (2004).

[68] 12 U.S.C.S. §1759 (2004).

[69] 12 U.S.C.S. §§1768 and 2902(2) (2004).

products and insurance companies.[70] All state insurance commissions also license insurance producers, although the exact type of licenses issued varies.[71] 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 reinsurance intermediaries.[72] In 2002, there were 7,173 domestic insurers and 3.8 million licensed insurance producers in the United States.[73]

3. Securities and Futures Regulatory Agencies

The 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.[74] 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.[75] SIPC only guarantees to return the securities. It does not guarantee the value of the securities.

Unlike bank regulators, federal and state securities regulators traditionally were not primarily focused on prudential concerns addressing the stability of the financial system and the solvency of the firms operating within it, but were more focused on protecting investors from fraud by requiring disclosure of all material information.[76] 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, like foreign banks or savings associations, and have a broker-dealer with a substantial presence in the securities markets.[77] Such financial conglomerates may elect to be supervised by the SEC as supervised investment bank holding companies ("SIBHC").[78]

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[70] National Association of Insurance Commissioners, 2002 Insurance Department Resources Report (2003). (hereinafter NAIC 2002 REPORT).

[71] *Id.*

[72] *Id.*

[73] *Id.* at 39 and 53.

[74] GART, *supra.* note 22 at 75.

[75] *Id.*

[76] MCCOY, *supra*. note 22 at §12.02[2].

[77] Supervised Investment Bank Holding Companies (Corrected Version), Release No. 34-49831 (Aug. 20, 2004) (available at <http://www.sec.gov/rules/final/34-49831.htm>).

[78] *Id.*

The CFTC regulates commodity futures and option markets, traders, brokers, futures commission merchants, commodity trading advisors, commodity pool operators and self regulating organizations, like the National Futures Association.[79] 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

Financial products and services continue to be regulated by the agencies that regulated such transactions prior to the adoption of GLBA with a few exceptions. 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.[80] Under GLBA, the state insurance commissions regulate the sales 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 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 offering. For example, bank regulators had regulated the securities activities of banks rather than the SEC. After the enactment of 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 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.[81] 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.[82]

GLBA also attempted to set up a system for determining which functional regulator should regulate new hybrid products. Section 205 of GLBA defines a "new hybrid product" as one that was not previously defined as securities before the enactment of GLBA and is not defined as an identified banking product within

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[79] Commodity Exchange Act, 7 U.S.C.S. §1 et. seq. (2004).

[80] GLBA, Title II; Michael P. *Malloy, Functional Regulation: Premise or Pretext?* in PATRICIA A. MCCOY, ED., FINANCIAL MODERNIZATION AFTER GRAMM-LEACH-BLILEY (LexisNexis: 2002) at 180.

[81] GLBA, §§ 201-202 (codified at 15 U.S.C.S. §78c(a)(4)-(a)(5) (2004)).

[82] GLBA § 201 (codified at 15 U.S.C.S. §78c(a)(4)(B) (2004)).

GLBA.[83] GLBA gave the SEC primary regulatory authority over new hybrid products that the SEC has determined are securities, provided that the SEC consults with and seeks the concurrence of the Federal Reserve before imposing broker-dealer registration requirements in connection with such hybrid products.[84] The definition for new hybrid product in Section 205 of 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.[85] GLBA in §104, however, did reaffirm that the states would retain control over the regulation of insurance products and services.[86]

5. Consolidation of State Financial Services Agencies

While the federal government enacted changes to the financial regulatory regime with the passage of 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 with either banking and securities, banking and insurance or securities and insurance in a single agency.[87] Fifteen states and the District of Columbia have created a single agency to supervise and regulate all financial services.[88]

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[83] GLBA §205 (codified at 15 U.S.C.S. §78o(i)(5)(D) (2004)). Section 206 of 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.

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

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

[86] GLBA §104.

[87] THE CONFERENCE OF STATE BANK SUPERVISORS, A PROFILE OF STATE CHARTERED BANKING 19ED. 2002-2003, 35 (2003); CA DEPT. FIN. INST. ANN. REP., 24 -25 (2002); GA DEPT. OF BANKING AND FINANCE ANN. REP. (2002); HI COMPLIANCE RES. FUND REP. (2002); IN DEPT. OF FIN. INST. ANN. REP., 16 (2002); IA ANN. REP. OF SUPERINTENDENT OF BANKING, 27 (2002); MS DEPT. BANKING & CONSUMER FIN. ANN. REP., 12-14 (2002); 2002 NY BANKING DEPT ORG. & MAINT. REP., 1 (2002); SC BOARD OF FIN. INST. ANN. ACCOUNTABILITY REP. (2002); VT ANN. REP. INS. COMMISSIONER, 10 (2002); WA DEPT. FIN. INST. ANN. REP., 2 (2002); WV ANN. REP. FIN. INST., 14, 18, 23 (2002); State of Illinois Department of Financial and Professional

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.

Regulation website, <www.idfpr.com> (accessed Nov. 2, 2004); Michigan Office of Financial & Insurance Services website <http://www.michigan.gov/cis/0,1607,7-154-10555-40268--,00.html> (accessed Aug. 29, 2004); North American Securities Administrators Association, Find Regulator <http://www.nasaa.org/nasaa/abtnasaa/find_regulator.asp> (accessed Jan. 3, 2005); and NAIC, Insurance Department Contacts, <http://www.naic.org/membership_services/docs/membershiplist.pdf> (accessed Jan. 3, 2005).

[88] The Conference of State Bank Supervisors, A Profile of State Chartered Banking 19ed. 2002-2003, 35 (2003); CA Dept. Fin. Inst. Ann. Rep., 24 -25 (2002); WA Dept. Fin. Inst. Ann. Rep., 2 (2002); HI Compliance Res. Fund Rep. (2002); IA Ann. Rep. of Superintendent of Banking, 27 (2002); MS Dept. Banking & Consumer Fin. Ann. Rep., 12-14 (2002); VT Ann. Rep. Ins. Commissioner, 10 (2002); State of Illinois Department of Financial and Professional Regulation website, <www.idfpr.com> (accessed Nov. 2, 2004); Michigan Office of Financial & Insurance Services website <http://www.michigan.gov/cis/0,1607,7-154-10555-40268--,00.html> (accessed Aug. 29, 2004); North American Securities Administrators Association, Find Regulator <http://www.nasaa.org/nasaa/abtnasaa/find_regulator.asp> (accessed Jan. 3, 2005); and NAIC, Insurance Department Contacts, <http://www.naic.org/membership_services/docs/membershiplist.pdf> (accessed Jan. 3, 2005).

States with Either an Integrated or Semi-Integrated Financial Services Agency as of March 1, 2005[89]

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	California	New Jersey	Tennessee	Alabama
Colorado	Connecticut			Arizona
District of Columbia	Idaho			Arkansas
Florida	Kentucky			Delaware
Hawaii	Louisiana			Georgia
Illinois	Montana			Indiana
Iowa	Nebraska			Kansas
Maine	New Mexico			Maryland
Michigan	Ohio			Massachusetts
Minnesota	Puerto Rico			Mississippi
Nevada	Washington			Missouri
Oregon	Wisconsin			New Hampshire
Rhode Island				New York
South Dakota				North Carolina
Vermont				North Dakota
Virginia				Oklahoma
				Pennsylvania
				South Carolina
				Texas
				Utah
				West Virginia
				Wyoming

[89] THE CONFERENCE OF STATE BANK SUPERVISORS, A PROFILE OF STATE CHARTERED BANKING 19ED. 2002-2003, 35 (2003); CA DEPT. FIN. INST. ANN. REP., 24 -25 (2002); GA DEPT. OF BANKING AND FINANCE ANN. REP. (2002); HI COMPLIANCE RES. FUND REP. (2002); IN DEPT. OF FIN. INST. ANN. REP., 16 (2002); IA ANN. REP. OF SUPERINTENDENT OF BANKING, 27 (2002); MS DEPT. BANKING & CONSUMER FIN. ANN. REP., 12-14 (2002); 2002 NY BANKING DEPT ORG. & MAINT. REP., 1 (2002); SC BOARD OF FIN. INST. ANN. ACCOUNTABILITY REP. (2002); VT ANN. REP. INS. COMMISSIONER, 10(2002); WA DEPT. FIN. INST. ANN. REP., 2 (2002); WV ANN. REP. FIN. INST., 14, 18, 23 (2002); State of Illinois Department of Financial and Professional Regulation website, <www.idfpr.com> (accessed Nov. 2, 2004); Michigan Office of Financial & Insurance Services website <http://www.michigan.gov/cis/0,1607,7-154-10555-40268--,00.html>

While the District of Columbia and most of the 15 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's 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."[90] Michigan created the OFIS in April 2000 by combining the Financial Institutions Bureau, the Insurance Bureau, and the Securities Bureau.[91] Frank Fitzgerald, who was the commissioner of the Michigan Insurance Bureau at the time that the OFIS was created and became the first commissioner to lead the OFIS, 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."[92] Initially, the OFIS had three divisions that essentially replicated the three former bureaus.[93]

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.[94] The Office of Financial Evaluation has four divisions: one division dealing with banks and trusts, one division dealing with credit unions, one division dealing primarily with insurance examinations, and one division dealing with supervising and monitoring financially troubled insurance companies.[95]

In the Office of Policy, Conduct, and Consumer Assistance, three of the four divisions deal with more than one financial sector.[96] The Consumer Services Division in the Office of Policy, Conduct, and Consumer Assistance acts as the initial point of contact for consumer inquiries and complaints.[97] The Conduct

(accessed Aug. 29, 2004); North American Securities Administrators Association, Find Regulator <http://www.nasaa.org/nasaa/abtnasaa/find_regulator.asp> (accessed Jan. 3, 2005); and NAIC, Insurance Department Contacts, <http://www.naic.org/membership_services/docs/membershiplist.pdf> (accessed Jan. 3, 2005).

[90] Michigan Office of Financial & Insurance Services website <http://www.michigan.gov/cis/0,1607,7-154-10555-40268--,00.html> (accessed Aug. 29, 2004).

[91] Michigan Office of Finance & Insurance Services, Department of Labor & Economic Growth, 2000 Michigan Office of Finance & Insurance Services Annual Report (2000).

[92] *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 1B.

[93] 2000 Michigan Office of Finance & Insurance Services Annual Report, supra. note 91.

[94] Michigan Office of Finance & Insurance Services, Department of Labor & Economic Growth, 2003 Michigan Office of Finance & Insurance Services Annual Report 7-8 (2003).

[95] *Id.*

[96] *Id*

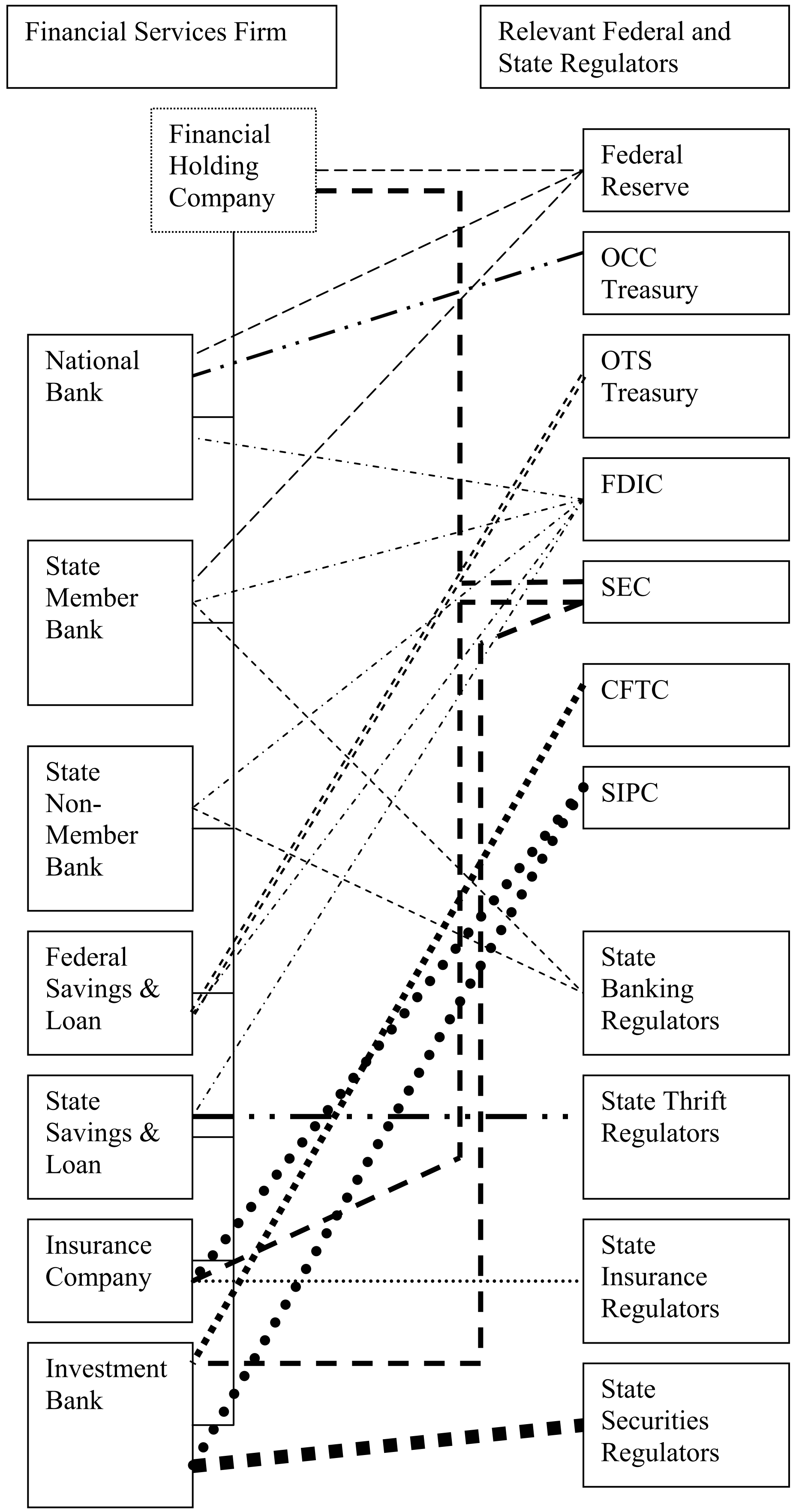
[97] *Id.*

Review and Securities Division in the Office of Policy, Conduct, and Consumer Assistance licenses mortgage brokers, securities brokers-dealers, investment advisors, securities agents, insurance agents, and insurance agencies as well as undertaking investigations and enforcement actions under all of the OFIS codes.[98] The Policy Division in the Office of Policy, Conduct, and Consumer Assistance provides research, policy analysis, and recommendations in support of all regulatory activities and policy development regarding the financial services industry.[99]

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 and is controlled by a financial holding company and owns a nationally chartered bank, a state chartered bank that was a member of the Federal Reserve System, a state chartered bank that was 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.[100]

[98] *Id.*
[99] *Id.*
[100] 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.


Financial Services Firm
Relevant Federal and State Regulators
Financial Holding Company
Federal Reserve
OCC Treasury
OTS Treasury
FDIC
SEC
CFTC
SIPC
State Banking Regulators
State Thrift Regulators
State Insurance Regulators
State Securities Regulators
National Bank
State Member Bank
State Non-Member Bank
Federal Savings & Loan
State Savings & Loan
Insurance Company
Investment Bank

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.[101]
- 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 that would assume the supervisory duties of the OCC, (2) the Administrator of State Banks that 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 that would assume the insurance functions of the FDIC, the FSLIC and the NCUSIF.[102]
- 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.[103]
- 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, and securities matters related to banks would be primarily the responsibility of the SEC.[104]
- 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.[105]

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

[102] *Id.* at 33.

[103] *Id.*

[104] *Id.* at 11-12 and 91-92.

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

- 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 would continue to supervise state banks and bank holding companies.[106]
- 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.[107]
- 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.[108]

None of these efforts were ever adopted. All of these efforts highlight 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.

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

Currently, the United States lacks a single forum in which all of the state and federal financial services regulators can meet to share information, to assess risks that cross traditional regulatory sectors, and to 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.[109] The GAO had the following dismal assessment of the existing efforts at cross-sector communication among the federal and state regulators:

[106] GAO FINANCIAL REGULATION REPORT, *supra.* note 8 at 76.
[107] *Id.*
[108] *Id.* at 77.
[109] GAO FINANCIAL REGULATION REPORT, *supra.* note 8 at 97-98.

> 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 . . .[110]

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.[111]

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").[112]

Of these, FFIEC, the President's Working Group, and 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.

FFIEC was created on March 10, 1979, pursuant to Title X of the Financial Institutions Regulatory and Interest Rate Control Act of 1978[113] (the "FFIEC Act)". FFIEC is comprised of the Federal Reserve, the FDIC, the

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[110] *Id.* at 109.

[111] GAO, LONG-TERM CAPITAL MANAGEMENT: REGULATORS NEED TO FOCUS GREATER ATTENTION ON SYSTEMIC RISK, GAO/GGD-00-3 (Oct. 29, 1999); GAO, FINANCIAL SERVICES REGULATORS: BETTER INFORMATION SHARING COULD REDUCE FRAUD, GAO-01-478T (March 6, 2001); GAO, STATE INSURANCE REGULATION: EFFORTS TO STREAMLINE KEY LICENSING AND APPROVAL PROCESSES FACE CHALLENGES, GAO-02-842T (June 18, 2002); GAO, POTENTIAL TERRORIST ATTACKS: ADDITIONAL ACTIONS NEEDED TO BETTER PREPARE CRITICAL FINANCIAL MARKET PARTICIPANTS, GAO-03-251 (Feb. 12, 2003); GAO, INSURANCE REGULATION: COMMON STANDARDS AND IMPROVED COORDINATION NEEDED TO STRENGTHEN MARKET REGULATION, GAO-03-433 (Sept. 2003); GAO, BANK TYING: ADDITIONAL STEPS NEEDED TO ENSURE EFFECTIVE ENFORCEMENT OF TYING PROHIBITIONS, GAO-04-4 (Oct. 2003); and GAO, BETTER INFORMATION SHARING AMONG FINANCIAL SERVICES REGULATORS COULD IMPROVE PROTECTIONS FOR CONSUMERS, GAO-04-882R (June 29, 2004).

[112] GAO FINANCIAL REGULATIONS 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.*

[113] Public L. No. 102-242, §111, 105 Stat. 2236 (1991).

NCUA, the OCC, and the OTS.[114] The mission of FFIEC is to prescribe uniform principles and standards for the examination of financial institutions and, following the enactment of GLBA, to have an increased coordinating role.[115] The President's Working Group was created by executive order in 1988 to analyze the 1987 stock market crash and was reactivated in 1994.[116] 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.[117] 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.[118] FBIIC is comprised of representatives from the Federal Reserve, FDIC, OCC, OTS, SEC, CFTC, NCUA, NAIC, CSBS, OFHEO, the Federal Housing Finance Board, the Office of Homeland Security, and the Office of Cyberspace Security.[119] 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.[120]

Inter-agency rivalries also have deterred efforts to expand the scope and composition of these groups in order to provide that kind of strategic assessment of the financial industry's risk. In June 2002, the Inspectors General of the Treasury, the FDIC, and the Federal Reserve completed a joint evaluation of FFIEC.[121] One of the items that they investigated was whether the membership of FFIEC ought to be broadened to include other regulators, like the SEC and the CFTC, in order to better assess the risks confronting the financial services industry. While the Inspectors General interviewed a range of people on the staffs of the agencies already on FFIEC, they did not interview anyone from the SEC or the CFTC nor did they obtain any information from these agencies regarding major risks or emerging issues facing the banking industry, despite the fact that banks are increasingly competing against other financial entities.[122] 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 to include agencies that regulate insurance and securities sectors.[123] The existing members of FFIEC also opposed creating a separate coordinating entity under GLBA in order to handle cross-sectoral issues, because they felt that the periodic

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[114] OFFICE OF INSPECTOR GENERAL, THE DEPARTMENT OF THE TREASURY, JOINT EVALUATION OF THE FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL 3-4 (OIG-02-099, June 21, 2002) (hereinafter OIG FFIEC REPORT)

[115] *Id.* at 3.

[116] GAO FINANCIAL REGULATION REPORT, *supra.* note 8 at 107.

[117] *Id.* The President's Working Group has address the 1997 market decline, year 2000 preparedness issues, and the growth of the over-the-counter derivatives market. *Id.*

[118] OIG FFIEC REPORT, *supra.* note 114 at 22.

[119] *Id.*.

[120] GAO FINANCIAL REGULATION REPORT, *supra.* note 8 at 107.

[121] OIG FFIEC REPORT, *supra.* note 114 at 22.

[122] *Id.*

[123] *Id.* at 6.

meetings called by the Federal Reserve or other ad hoc arrangements adequately dealt with cross-sectoral issues.[124]

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."[125] 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.[126] The report also commented that coordination with state banking regulations needs to be improved.[127] Currently, five state banking commissioners comprise the State Liaison Committee to the FFIEC, but these commissioners do not have voting rights on the FFIEC.[128]

Out of the three existing inter-agency forums, only FBIIC contains representatives from the insurance regulators. When questioned by the Inspectors General about expanding FFIEC to include insurance regulators, the existing members of FFIEC pointed to the bilateral information sharing agreements between the banking agencies and state insurance commissioners as effective mechanisms for sharing relevant regulatory information.[129] 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.[130] 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.[131] 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.

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, by law, FFIEC has no ability to force agency members to adopt a particular proposal, but serves only as a coordinating and policy-making entity.[132] Because FFIEC lacks rulemaking authority, any

[124] *Id.*
[125] *Id.*
[126] *Id.*
[127] *Id.* at 9.
[128] *Id.*
[129] *Id.* at 18.
[130] *Id.*.
[131] *Id.*.
[132] 12 U.S.C.S. §3305 (2004).

projects resulting in rulemaking must be issued jointly by the relevant agencies.[133] In addition, FFIEC's effectiveness seems to be contingent on who the members are at a given time.[134] Second, not all agencies are involved in FFIEC, rendering it ineffective for handling issues that must be dealt with quickly or involve agencies that are not members.[135]

2. Current System Contains Inconsistent Regulations

Inconsistent regulations exist within the current regulatory regime, because functional regulation was imperfectly enacted in 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.[136] In addition, national banks can continue to engage in underwriting of insurance products, which the Office of the Comptroller of the Currency ("OCC") had authorized national banks to provide as of January 1, 1999.[137]

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. GLBA did give the SEC primary regulatory authority over new hybrid products that the SEC has determined are securities, provided that the SEC consults with and seeks the concurrence of the Federal Reserve before imposing broker-dealer registration requirements in connection with such hybrid products.[138] Section 205 of GLBA defines "new hybrid product" as one that was

[133] OIG FFIEC REPORT, *supra.* note 114 at 7.

[134] *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 important at all levels of the FFIEC and that without good relationships there is no basis for completing interagency projects." *Id.*

[135] *Id.* at 10. Even FBIIC 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.

[136] GLBA § 201 (codified at 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.

[137] GLBA §302.

[138] GLBA §205 (codified at 15 U.S.C.S. §78o (2004)).

not previously defined as securities before the enactment of GLBA and is not defined as an identified banking product within GLBA.[139]

The definition for new hybrid product in Section 205 of GLBA, as previously noted, 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.[140] 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.

GLBA in §104 reaffirmed that the states would retain control over the regulation of insurance products and services.[141] Nevertheless, GLBA §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.[142] GLBA permits states to collect, review and take actions (including the 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.[143]

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.[144] Thus, these regulations decrease competition and distort the markets for financial products.

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[139] GLBA §205 (codified at 15 U.S.C.S. §78o(i)(5)(D) (2004)). Section 206 of 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.

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

[141] GLBA §104.

[142] GLBA §104(c).

[143] GLBA §104(c)(2). In the event of a dispute between federal regulators and state insurance regulators regarding insurance, 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. GLBA §304, 15 U.S.C.S. 6714 (2004).

[144] 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

3. Current System Contains Duplicative Regulations

Numerous studies have identified the problem of overlapping regulatory authorities producing inconsistent regulations.[145] For example the GAO 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. In addition, 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.[146] The Bair Report concluded that the duplicative nature of state insurance regulations resulted in multiple state reviews of product filings that are cumbersome and inefficient and 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.[147]

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.[148] 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.[149]

GLBA also required states to establish uniform or reciprocal requirements for licensing of insurance agents.[150] GLBA mandated that NAIC had to determine whether a majority of states had to meet this requirement within three years after the enactment of GLBA.[151] If 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,

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certain market are regulated in one way and others in a different way, leads to competitive unfairness and customer confusion.").

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

[146] BAIR REPORT, *supra.* note 22, 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.

[147] *Id.*

[148] *Regulators Issue Common Form*, BANKING & FIN. SERVICES POLICY RPT. 7 (Aug. 2002).

[149] *Id.*

[150] §321, 15 U.S.C.S. 6751 (2004).

[151] *Id.*.

appointment, continuing education, and other insurance producer sales qualification requirements and conditions" could be adopted.[152]

Perhaps not surprising, when given a choice between reciprocity and uniformity, the states chose reciprocity over uniformity.[153] Reciprocity only required that 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, NAIC had certified 41 states as meeting the reciprocity requirements under the GLBA.[154] Nevertheless, major states, like California, New York and Florida, still have not complied with the reciprocity requirements.[155] 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.[156] Both industry representatives and NAIC have admitted that until states with large insurance markets reciprocate in the licensing process, the states' reciprocity initiative would not be completely successful.[157]

In reviewing NAIC's progress in complying with 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**."[158] 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."[159]

The state insurance regulators through NAIC have unsuccessfully attempted several times to centralize the filing and approval process for some

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[152] §322-323, 15 U.S.C.S. 6752-6753 (2004).

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

[154] Responding to the NARAB Requirement <http://www.naic.org/GLBA/narab.htm> (accessed Dec. 29, 2004).

[155] *Id.*

[156] *Id.*

[157] Hillman, *supra.* note 153 at 2. In addition, the GAO noted that some state licensing requirements that were waived in order to meet the reciprocity requirements under GLBA have been recharacterized as postlicensing requirements, which undermines GLBA's intended benefits of streamlining insurance regulations. *Id.* at 7.

[158] [Emphasis added.] *Id.* at 16.

[159] *Id.* at 17.

types of life and health insurance products[160] and to facilitate the licensing process for companies that want to provide insurance on a multi-state basis.[161]

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 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 occasionally occur in baseball when to two outfielders each assume that the ball is heading towards the other's area of the field and so make no attempt to catch it, resulting in the ball dropping between the two of them, hitting the field and the runner at least getting on base, if not scoring.[162] 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 wining economists Robert Merton and Myron

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[160] Hillman, *supra*. note 153, at 2; NAIC, INTERSTATE INSURANCE PRODUCT REGULATION COMPACT, Art. III (July 2003); NAIC, INTERSTATE INSURANCE PRODUCT REGULATION COMPACT <http://www.naic.org/GLBA/narab.htm> (accessed Dec. 29, 2004).

[161] 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 153, 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 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. 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.

[162] 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. Neither the FTC, the FDIC, nor the NCUA, however, want to be responsible for enforcing this section. The FTC had gotten Congress enact as part of its appropriations bill a passage that prohibits the FTC from enforcing Section 43. 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 (August 2003).

Scholes.[163] LTCM initially specialized in high-volume arbitrage trades in bond and bond-derivatives markets, but eventually began to engage in other markets and in speculation.[164] By the end of 1997, LTCM had developed an impressive track record with an average annual rate of return of approximately 40 percent.[165] 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.[166]

In order to achieve the rate of return for which they were aiming, they decided that they needed to return $2.7 billion of capital to the shareholders.[167] LTCM took a gamble that by making the fund riskier that it would enhance the returns for its shareholders.[168] The markets, however, deteriorated in the summer of 1998, which led to major losses for LTCM in July of 1998.[169] In August of 1998, the Russian government devalued the ruble and declared a moratorium on future debt repayments.[170]

Unfortunately for LTCM, this resulted in the spreads between the prices of Western government and emerging market bonds widening.[171] LTCM had taken speculative positions based on their assumptions that such spreads would narrow.[172] By September 19, 1998, the fund's capital had fallen to $600 million and its assets were down to $80 billion.[173] LTCM was not expected to survive without outside assistance.[174]

On September 20th, the New York Federal Reserve and the U.S. Treasury met with LTCM partners to ascertain whether the U.S. government needed to intervene.[175] The LTCM partners were able to convince the government delegation that the situation was much worse than market participants thought.[176] 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.[177]

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

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163 Kevin Dowd, *Too Big to Fail? Long-Term Capital Management and the Federal Reserve*, CATO INSTITUTE BRIEFING PAPERS NO. 52, 2 (Sept. 23, 1999).

164 *Id.* at 3.

165 *Id.*

166 *Id.*

167 *Id.*

168 *Id.*

169 *Id.*

170 *Id.*

171 *Id.*

172 *Id.*

173 *Id.* at 4.

174 *Id.*

175 *Id.*

176 *Id.*

177 *Id.*

originally supposed to meet on September 23rd, but delayed their meeting to see how LTCM would respond to an offer made by a group comprised of Berkshire Hathaway, Goldman Sachs and American International Group.[178] 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.[179]

LTCM rejected the offer of Berkshire Hathaway, Goldman Sachs and American International Group. Some have speculated that LTCM rejected the offer because the LTCM managers expected to get a better offer from the Federal Reserve consortium.[180] The package ultimately offered by the creditor consortium put together by the Federal Reserve 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.[181] In addition, the LTCM managers were allowed to retain their jobs.[182] By the end of 1998, LTCM had once again resumed making profits.[183]

The Federal Reserve was acting without a mandate when it intervened in the LTCM crisis. It was not responsible for regulating hedge funds. LTCM also 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[184], the Securities Exchange Act of 1934[185], and the Investment Company Act of 1940.[186] In addition, such hedge funds were not regulated by any other regulatory agency.[187] In fact, the majority of U.S. hedge funds had restricted the number of their shareholders to fewer than 100 to avoid being regulated.[188] Overseas hedge funds were subject to little or no regulation and as a result, the hedge-fund industry was essentially unregulated.[189] Nevertheless, these firms can have profoundly negative impacts on the financial markets if they become insolvent, like LTCM.[190]

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[178] *Id.*
[179] *Id.*
[180] *Id.* 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.
[181] *Id.*
[182] *Id.*
[183] *Id.*
[184] ch. 38, Title 1, §1, 48 Stat. 74 (1933)(codified 15 U.S.C.S. §78a et. seq.).
[185] ch. 404, Title 1, §1, 48 Stat. 881 (1934)(codified 15 U.S.C.S. §78a et seq.).
[186] ch. 686, Title II, §220, 54 Stat. 857 (codified 15 U.S.C.S. §806-1 et seq.).
[187] Dowd, *supra.* note 163, at 2-3.
[188] *Id.* at 3.
[189] *Id.*
[190] Over fiver 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

While many other regulatory gaps exist, no forum or mechanism has been established to assess them and 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 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, GLBA has allowed a wide range of conflicts of interest to develop and fester.

For example, financial conglomerates increasingly are being accused of conditioning commercial lending on commitments by the borrowers to also use the bank's investment banking services.[191] This practice is problematic for several reasons.

First, it 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 conditioning bank loans 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.[192] The Association for Financial Professionals published the results of a credit access survey in March 2003.[193] This survey examined the extent to which the extension of 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

funds to register with the SEC. SEC, Final Rule: Registration Under Advisers Act of Certain Hedge Fund Advisers, SEC Release No. IA-2333.

[191] 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 <http://www.iddmagazine.com/idd/NYTSStories/1031551057358.htm> (Jan. 6, 2003).

[192] Sapsford and Beckett, *supra.* note 191, at A1 & A11.

[193] ASSOCIATION FOR FINANCIAL PROFESSIONALS, CREDIT ACCESS SURVEY: LINKING CORPORATE CREDIT TO THE AWARDING OF OTHER FINANCIAL SERVICES (March 2003).

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.[194] This problem was most acute when the company failed to award the commercial bank investment banking business.[195] 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.[196]

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 the companies did not award the commercial bank other business.[197] 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.[198]

The pressure from banks is growing. Fifty-six percent of large company respondents and about 20 percent of all company respondents stated that this pressure to award additional business had grown over the prior year.[199] 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.[200]

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.[201] No respondent to the survey indicated that they had 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.[202] Another reason why tying has not been reported to regulators is because it is hard to prove.[203] 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 "There's always documentation in the file that these laws were not violated."[204]

[194] *Id.* at 5.
[195] *Id.*
[196] *Id.* at 2.
[197] *Id.*at 11.
[198] *Id.*
[199] *Id.* at 9.
[200] *Id.*
[201] *Id.* at 11.
[202] *Id.* at 3.
[203] O'Leary, *supra*. note 191.
[204] *Id.*

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."[205]

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.

Bankers have acknowledged that traditional bank lending is not very profitable and that other business with the company effectively subsidizes the bank loans.[206] 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.[207]

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.[208] 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, in part 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".[209] J.P. Morgan Chase & Co. incurred $1.4 billion in costs due to loans made to companies in the telecommunications and cable sectors in anticipation of the investment banking business that these companies would provide in exchange for the loans.[210]

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.[211] 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.[212] 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.[213] Shortly after making the loan, Vivendi's stock and bond prices began to decline and the ratings

[205] *Id.*
[206] Sapsford and Beckett, *supra.* note 191, at A1; Jake Keaveny, *IPO View – Wall Street Banks Lend More to Win Business*, REUTERS (Feb. 3, 2003); O'Leary, *supra*. note 191.
[207] Keaveny, *supra.* note 206.
[208] Sapsford and Beckett, *supra.* note 191, at A11; O'Leary, *supra*. note 191.
[209] Sapsford and Beckett, *supra.* note 191, at A11.
[210] *Id.*
[211] *Id.*
[212] *Id.*
[213] *Id.*

for Vivendi's debt were downgraded, preventing the bond sale from going forward.[214] Vivendi's financial troubles also raised questions about whether it would be able to repay the $1.6 billion loan.[215]

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."[216] The chief executives of Merrill Lynch and J.P. Morgan Chase have stated that banks that want to win debt and equity deals need to also be able to supply loans.[217] Vodaphone 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.[218] Clients were able to wield this power in the hypercompetitive environment that the deregulation of the financial services sector spawned.[219] Ralph Della Ratta, head of investment banking at Cleveland-based McDonald Investments, explained that "The 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."[220]

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 are. Federal Reserve Chairman Alan Greenspan and Comptroller of the Currency John D. Hawke 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.[221] 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.[222] 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.[223]

[214] *Id.*
[215] *Id.*
[216] O'Leary, *supra*. note 191.
[217] Keaveny, *supra*, note 206.
[218] O'Leary, *supra*. note 191.
[219] *Id.*
[220] *Id.*
[221] Riva D. Atlas, *Corporations in Survey Say Banks Tie Loans to Other Business*, N.Y. TIMES (March 19, 2003).
[222] GAO, BANK TYING: ADDITIONAL STEPS NEEDED TO ENSURE EFFECTIVE ENFORCEMENT OF TYING PROHIBITIONS, GAO-04-4, 5 (Oct. 2003).
[223] *Id.*

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.[224] In February 2003, several commercial banks, including Citigroup, JP Morgan Chase, the Bank of America, and Deutsche Bank, reportedly attempted to prevent NASD from investigating the tying allegations on the grounds that lending operations were outside of NASD's jurisdiction.[225] 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.[226]

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 for ever larger 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 Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994[227] that eliminated the barriers to interstate banking, both of which allowed super regional banks to form. Such mergers allow bank holding companies to be more diversified both geographically and across economic sectors, which leaves them less vulnerable to regional or sectoral slumps.[228]

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.[229] As Arthur J. Rolnick, the research director at the Federal Reserve Bank of Minneapolis in 1998, noted: "With the safety net starting to extend beyond banking, the potential taxpayer exposure has grown."[230]

The capital structure of such megabanks could be undermined by excessive speculation by the traders in its investment banking subsidiary or by mismanagement of underwriting by its insurance subsidiary.[231] Federal regulators may feel compelled to bailout such financial conglomerates out of concern that allowing such a bank to fail would have a cascade effect on the financial system,

[224] *Id.*

[225] Gary Silverman and Adrian Michaels, *Leading US Banks Unite to Fight 'Tying' Probe*, FIN. TIMES (Feb. 10, 2003).

[226] *Id.*

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

[228] Dean Foust, *Commentary: If This Safety Net Snaps, Who Pays?* BUSINESS WEEK (April 27 1998).

[229] Foust, *supra.* note 228; O'Leary, *supra.* note 191. ("'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.")

[230] Foust, *supra.* note 228.

[231] *Id.*

which would cause other financial institutions to also collapse.[232] The sheer size of such institutions may breed a sense within them that they are "too big to fail".[233]

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.[234] When looking solely at the information embedded in share prices, the evidence that this is in fact a motivation for bank mergers is mixed.[235] However, when looking at bond prices, evidence has been found that one factor motivating some bank mergers is a desire 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 FDIC, would consider it too costly to close the bank.[236] 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.[237] 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.[238]

Evidence of the "too big to fail" mindset in sectors other than banking also already exists.[239] In late 2001, MJK Clearing ("MJKC"), a medium-size broker-dealer firm headquartered in Minneapolis, was suffering severe financial

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[232] *Id.*

[233] *Id.*

[234] *Id.* at 1.

[235] Edward Kann, *Incentives for banking megamergers: What motives might regulators infer from event-study evidence?* 32 J. MONEY, CREDIT & BANKING (2000) (argued 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, and L. Wall, *Motivations for Bank Mergers and Acquisitions: Enhancing the Deposit Insurance Put Option versus Earnings Diversification*, 28 J. OF MONEY, CREDIT & BANKING (1995) (did not find that acquirers would 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*, J. FIN. ECON. 59 (2001) (reported 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).

[236] Maria Fabiana Penas and Haluk Unal, *Too-Big-To-Fail Gains in Bank Mergers: Evidence from the Bond Markets* (July 1, 2001) at 1.

[237] *Id.* at 3.

[238] *Id.* at 3-4.

[239] Gary H. Stern and Ron Feldman, *Too Big to Fail: The Hazards of Bank Bailouts*, FEDERAL RESERVE BANK OF MINNEAPOLIS THE REGION (December 2003).

difficulty.[240] 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 assistance to it.[241] 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.[242] Ultimately, no assistance was provided and MJKC became the largest liquidation of a securities broker by the Securities Investor Protection Corporation.[243] Fortunately, the initial claims of financial and economic disruption proved to be exaggerated.[244]

Actions, such as the rescue of LTCM, exacerbate the "too big to fail" mentality within the financial community.[245] The LTCM rescue created the perception that the Federal Reserve has assumed the 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 activity.[246] The Federal Reserve arguably has put itself in the position of being responsible for hedge funds while having no power over them.[247] 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.[248] Arguably the Federal Reserve's actions in the case of LTCM have raised concerns about whether the Federal Reserve will become responsible for other financial firms, especially those that are similar to hedge funds, for which it does not currently have regulatory authority but which the Federal Reserve deems "too big to fail."[249]

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

[240] *Id.*
[241] *Id.*
[242] *Id.*
[243] *Id.* (citing Securities Investor Protection Corporation, 2001 Set Record for Number of Customers Paid, Amount of Advances, news release, March 13, 2002).
[244] *Id.*
[245] Dowd, *supra.* note 163, at 2.
[246] *Id.* at 9.
[247] *Id.*
[248] *Id.*
[249] *Id.* at 10.

foreign-owned company, slightly more than double the 69 such firms in 1995.[250] In addition, U.S. investors purchased $2.5 trillion worth of foreign securities in 2003.[251]

U.S. firms operating abroad must comply with an additional layer of regulation. U.S. regulators also are participating more frequently 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 regularly 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").[252] The rules developed by these organizations ultimately will influence U.S. regulations in the area of banking, securities and insurance.

For example, 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.[253]

Basel II requires financial entities that engage in financial leasing, the issuance of credit cards, portfolio management, investment advisory services,

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[250] GAO FINANCIAL REGULATION REPORT, *supra.* note 8 at 45.

[251] *Id.*

[252] GAO FINANCIAL REGULATION REPORT, *supra.* note 8 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. *Id.* The SEC participates as a member and the CFTC participates as an associate member in the IOSCO. *Id.* 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. *Id.*

[253] BASEL II CAPITAL ACCORD, *supra*. note 1 at 7.

custodial and safekeeping services and other similar activities to be captured through consolidation.[254]

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 from those items to be captured through consolidation.[255] 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.[256] 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 to deduct its investments in insurance subsidiaries and significant minority investments in insurance entities from its equity and other regulatory capital, then Basel II recommends that the bank ensure any alternative approaches, which it uses, avoid double counting of capital.[257] Basel II recognizes that the capital invested by a bank's majority-owned or controlled insurance entity may exceed the amount of regulatory capital required for the insurance entity by the relevant insurance regulator.[258] Basel II 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.[259] Basel II allows 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.[260] 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.[261]

Even regional efforts to harmonization 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[262] ("EU FCD"), which requires supervisors and financial groups to measure on a

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[254] *Id.* at 7, n. 6.
[255] *Id.* at 7, n 5.
[256] *Id.* at 8.
[257] *Id.* at. 8-9.
[258] *Id.* at 9.
[259] *Id.*
[260] *Id.*
[261] *Id.*
[262] 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). (may be accessed at <http://europa.eu.int/eur-lex/pri/en/oj/dat/2003/l_035/l_03520030211en00010027.pdf>) (hereinafter the FINANCIAL CONGLOMERATES DIRECTIVE).

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.[263] 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.[264] In addition, the amendments in the EU FCD to the banking, investment and insurance group directives are the first steps at the EU level towards treating financial service providers consistently across sectors.[265]

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.[266] While the US system of supervision requires this in the case of bank holding companies, financial holding companies, and thrift holding companies, it does not currently require it for financial conglomerates comprised of financial service providers other than banks.[267] 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.[268]

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 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.[269] In addition, NAIC is a cumbersome vehicle for handling international problems in the insurance area, like the insolvency of Equitable Life. As a result, the officials from the EU, UK FSA, and BaFin all informed the GAO that they would prefer to deal with a single

[263] *Id.* at Ch. II, § 1, Arts. 5-9.
[264] *Id.* at Preamble ¶¶ (1) and (2).
[265] *Id.* at Preamble ¶ (4).
[266] *Id.* at Ch. II, §4, Art. 18.
[267] GAO FINANCIAL REGULATION REPORT, *supra.* note 8 at 5.
[268] GAO FINANCIAL REGULATION REPORT, *supra.* note 8 at 7-8.
[269] *Id.* at 123.

insurance regulator at the federal level in the United States than continuing to deal with NAIC.[270]

Second, having multiple U.S. regulators with divergent agendas participating in international negotiations, like the Basel II Accord, undermines the effectiveness of these negotiators and creates confusion for their counterparts from other countries.[271] 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 could not coordinate their efforts better.[272]

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 to advance their interests than other groups, 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 provided 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.[273]

Agency capture occurs more frequently in agencies that regulate only one special interest group.[274] In the financial services industry, specialized agencies, like 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.[275]

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[270] Id.

[271] Id. at 122.

[272] Id. at 8.

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

[274] *Id.* at 103.

[275] How much each of these regulators has been captured by their constituents has been debated. Ratner, *supra.* note 144, at 1776 ("Unlike the regulators of banks, thrift institutions, and insurance companies, which have acted principally as protectors and advocates for their

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.[276] 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 Texas that had set up special agencies to regulate only thrifts.[277] 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.[278]

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."[279] In the recent accounting scandals involving Fannie Mae and Freddie Mac, OFHEO has been strongly criticized for being captured the entities that it is supposed to be regulating.[280]

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.[281] 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.[282] In response to

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.").

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

[277] Ramirez, *supra*. note 101 at 554 n. 299.

[278] Ralph Nader, *The Secret World of Banking, In the Public Interest*, THE NADER PAGE (July 9, 2002).

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

[280] Stephen Labaton, *New Agency Proposed to Oversee Freddie Mac and Fannie Mae*, N.Y. TIMES (Sept. 11, 2003).

[281] Croley, *supra*. note 273, at 15-16; Ramirez, supra. note 101, at 518.

[282] Stephan Taub, *SEC Boosting Big-Company Caseload*, CFO.COM (March 9, 2004). 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/How we are funded <http://www.fsa.gov.uk/funding/> (accessed Dec. 31, 2004). 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) <http://banking.senate.gov/docs/csma/schumer.htm> (accessed Dec. 31, 2004). During the 1990s,

the public outcry over the Enron and Worldcom scandals, Congress reversed itself and increased the SEC's budget almost 33 percent to $716 million in 2003, from the $540 million that it received in 2002.[283] The SEC has requested a budget of $913 million for fiscal year 2005, which is 69 percent more than its 2002 budget.[284] 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.[285]

Few federal or state regulators, other than the Federal Reserve, have control over their budgets. Research indicates that the Federal Reserve has been less likely to be captured by the banks, bank holding companies, and financial holding companies that it regulates than other U.S. agencies, like the SEC, because it has control over its budget rather than having it set by Congress or a state legislature.[286]

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 harms 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.[287] The GAO has recommended that states grant their regulators this authority.[288] The GAO 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, "However, if 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 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

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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. Taub, *supra*.

[283] Taub, *supra*. note 282.

[284] *Id.*

[285] 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.*

[286] Ramirez, *supra*. note 101, at564.

[287] Hillman, *supra*. note 153 at 6.

[288] *Id.*

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."[289]

Obviously, not all states have acted as strong consumer advocates. Only 15 states and cities have adopted laws prohibiting predatory lending.[290] Pennsylvania overturned a Philadelphia law against predatory lending and Maryland block efforts in Baltimore to adopt a law prohibiting predatory lending.[291] The fact that most states do not offer consumers protection against predatory lending at the current time supports the position that it would 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 provide some evidence that consumer protections may increase if regulatory power was 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."[292] 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 off against each and to seek more compatible regulators when they get into trouble.[293] 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.[294] His study examined regulatory switches that occurred between 1983 and 1999. Rosen concluded that his control variables were important 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.[295] Rosen notes that much of the explanatory power of his regressions comes from the merger variable and the holding company variables, which conform with the view that most switches are motivated by

[289] *Id.* at 16.

[290] 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*, NEWS J. (Aug. 10, 2003).

[291] *Id.*

[292] 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).

[293] Ramirez, *supra*. note 101, at 507-508.

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

[295] *Id.* at 980.

organizational issues within banks as opposed to other factors.[296] Rosen comments that, when risk is controlled for within his model, large changes in bank portfolios result in a higher probability of bank switching regulators.[297] From these facts, Rosen concludes that the bank supervisors' desire for a quiet life result in their preference for banks with as simple a portfolio to evaluate as possible and, therefore, bank supervisors will encourage banks that want to make significant changes in their portfolios to change regulators.[298]

A number of problems have been raised regarding Rosen's methodology by Gary Whalen.[299] 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.[300] Whalen comments, "The 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."[301] 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."[302] While Rosen 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.[303]

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.[304] Rosen notes that banks that are increasing the size of their consumer loan portfolio are more likely to shift regulators to the

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[296] *Id.* at 983.

[297] *Id.*

[298] *Id.* at 983-4.

[299] Gary Whalen, *Charter Flips by National Banks*, ECONOMIC AND POLICY ANALYSIS (Office of the Comptroller of the Currency, U.S. Department of the Treasury, Working Paper 2002-1, June 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.

[300] Whalen, *supra.* note 299 at 6.

[301] *Id.* at 7.

[302] *Id.*

[303] Rosen, *supra.* note 294 at 979.

[304] *Id.* at 980.

OCC, while banks that are increasing the size of their commercial loan portfolio (including commercial real estate loan) 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.[305]

From this data, Rosen concludes that each of the federal regulators was specializing in regulating banks with these concentrations in their loan portfolios and that this is evidence of regulatory competition leading to optimal standards setting.[306] He also notes 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.[307] He assumes that these movements are publicly beneficial because the banks did not fail following such a switch, but their revenues generally rose after these moves.[308]

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, but 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, by applying it to loans to individuals or entities located throughout the United States. Subprime lenders seek the ability to charge very high rates of interests to certain classes of consumers. By establishing a national bank and processing loans in a state, which lacks laws limiting the interest rates that may be charged, a bank can engage in subprime lending on a national scale. Many banks have sought to expand their subprime consumer lending in recent years. Subprime lending has the greatest potential to be classified as predatory lending. Increases in predatory lending are not desirable.[309]

Second, the fact that banks did not fail following a switch may be due to the fact that the Depository Institutions Deregulation and Monetary Control Act of 1980 ("DIDMCA") mandated that all depository institutions, regardless of which regulator supervised them, must comply with the reserve requirements set by the Federal Reserve Board of Governors.[310] Reserve requirements are one of the most important tools used by bank regulators to prevent bank failures.

[305] *Id.* at 990.
[306] *Id.* at 969 and 990.
[307] *Id.*
[308] *Id.*
[309] Elizabeth R. Schiltz, *The Amazing, Elastic, Ever-Expanding Exportation Doctrine and Its Effect on Predatory Lending Regulation*, 88 MN L. R. 518, 522, 544 (Feb. 2004).
[310] 70 Pub. L. No. 96-221, 94 Stat. 132 (1980) (codified in various sections of 12 U.S.C.). For a discussion of how the DIDMCA eliminated state-federal competition in the area of reserve requirements, see Henry N. Butler and Jonathan R. Macey, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677 (May, 1988).

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.[311] Rosen only examined banks that changed their primary regulators during the period from 1983 to 1999.[312]

In addition, converting charters 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.[313] CAMELS ratings are used by the OCC's examiners to assess a bank's risk management systems. "CAMELS" stands for: Capital adequacy, Asset quality, Management administration, Earnings, Liquidity, and Sensitivity to market risk.[314] 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 again on a 1 to 5 scale, with 1 being the strongest performance and 5 signally critically deficient performance.[315]

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.[316] Thus, it appears that banks with more problematic portfolios were moving towards state charters while banks with less problematic portfolios were moving towards federal charters.

In the study done by Gary Whalen, several indicators of bank risk significantly increased the likelihood that a national bank would exchange its charter for a state charter.[317] Charter flips were more likely to occur in more competitive markets and in states where past flip activity was high.[318] In addition, banks were more likely to flip their charter after receiving a less favorable management rating by supervisors.[319] Banks also were more likely to flip their charter when their CAMEL ratings worsen or when banks were subjects of formal enforcement actions.[320] Whalen admits that his research does not explain the motivations behind such bank charter changes, although he speculates that it might either be due to bank management seeking a more amendable supervisor or to bank supervisors encouraging problem banks to change their charters.[321] The

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311 Butler and Macey, *supra.* note 310 at 695-696.
312 Rosen, *supra.* note 294 at 975.
313 Butler and Macey, *supra.* note 310 at 686-689; Whalen, *supra.* note 299 at 17.
314 COMPTROLLER'S CORPORATE MANUAL, A GUIDE TO THE NATIONAL BANKING SYSTEM 20-21 (May 1999).
315 *Id.*
316 Rosen, *supra.* note 294 at 979.
317 Whalen, *supra.* note 299. at 7-9.
318 *Id.* at 30.
319 *Id.*
320 *Id.*
321 *Id.* at 30.

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 the initial regulatory approvals are high, but once they have been overcome 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 rewards.

An example of a product that has had its development hampered by the present regulatory structure is home equity insurance.[322] For most Americans, the equity that they own in their home is their largest asset. Nevertheless, the average family has almost no access to any form of insurance to protect against drops in the value of the home. There have been a few instances where home equity insurance or home price insurance has been offered, such as Oak Park, Illinois in the 1970s and Syracuse, New York beginning in 2002.[323] These programs were sponsored by nonprofit corporations that sought 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 sales value of the home.[324] 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.[325]

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.[326] 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."[327] 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

[322] ANDREW CAPLIN, WILLIAM GOETZMANN, ERIC HANGEN, BARRY NALEBUFF, ELISABETH PRENTICE, JOHN RODKIN, MATTHEW SPIEGEL, AND TOM SKINNER, HOME EQUITY INSURANCE: A PILOT PROJECT (Yale International Center for Finance Working Paper No. 03-12, May 3, 2003).
[323] *Id.* at 3 and 5.
[324] *Id.* at 5.
[325] *Id.* at 1-2.
[326] *Id.* at 24-26.
[327] *Id.* at 25.

interest" because he did not have a material interest in the index upon which the pay out would be based.[328] 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.[329] 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.[330]

Under the current regulatory regime, an insurance company seeking to introduce a new product, like the home equity policy, nationwide 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 educating insurance regulators about the new product's attributes while 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 educating regulators about the product's attributes. Products, like the home equity policy, which are very useful for homeowners may not be introduced into the market because the first insurance company to introduce the product may not recoup sufficient profits to offset its higher costs due to the initial regulatory approval process before other companies enter the market and drive prices and profits down.

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 more disclosure.[331] Bank regulators and insurance regulators are more paternalistic with the types of regulations that they imposed to ensure the safety and stability of banks and insurance companies.[332] As a result, the existing financial regulators do not tend to be very innovative when thinking about what types of regulations to propose. The lack of regulatory innovations 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.[333] 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 trade securities through his bank and buy insurance from his bank.

[328] *Id.*

[329] *Id.* at 26. A Price-Level Adjusted Mortgage is a mortgage that adjusts the principal of the mortgage based on an index, like inflation. *Id.* at 26 n. 14.

[330] *Id.* at 27.

[331] MCCOY, *supra* note 22 at §12.02[2].

[332] *Id.*

[333] GAO FINANCIAL REGULATIONS REPORT, *supra.* note 8.

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. U.S. Financial Regulatory Regime is More Expensive Than Any Other Developed Country's Financial Regulatory Regime

The U.S. pays considerably more than any other developed country to regulate its financial services industry, but it is questionable whether the United States is getting a proportionally better regulatory regime for its money. The UK FSA included in its Annual Report 2002/03 data that it had collected from the regulatory authorities in Australia, Canada, France, Germany, Hong Kong, Ireland, Singapore, Sweden and the United States concerning how much each spent to operate their financial regulatory agencies.[334] 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.[335]

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[334] UK FSA, ANNUAL REPORT 2002/03 205-210 (2003). 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) material differences in the size and nature of the financial services industries in each country exist. *Id.*

[335] UK FSA, ANNUAL REPORT 2002/03, *supra*. note 334, at 206-207. 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 £3,008.8 million (approximately $4,663.6 million), the total regulatory costs for the United Kingdom were £249million (approximately $385.95 million), and the total regulatory costs for Germany were £35million (approximately $54.25 million). UK FSA, ANNUAL REPORT 2002/03, *supra*. note 334, at 206-207; Federal Reserve Statistical Release, *United Kingdom Historical Rates* <www.federalreserve.gov/releases/H10/Hist/dat00_uk.htm> (released dated Dec. 20, 2004). 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* <www.federalreserve.gov/releases/H10/Hist/dat00_uk.htm> (released dated Dec. 20, 2004).

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, Presentation at the "Do Financial Supermarkets Need Superregulators? Conference of the Center for the Study of International Business Law and the Brooklyn Journal of International Law (Sep.

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 nor does it include the amounts spent by the states for banking and securities regulation.[336] The total regulatory costs for the United States for 2002 would be more than 16 times the annual expenses of the UK FSA and more than 117 times the annual expenses of Germany's BaFin, if all of 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 consolidated.[337]

The disparities in regulatory costs between the United Kingdom, Germany and the United States are greatest in the area of banking regulation. In 2002/03,

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.*

[336] UK FSA, ANNUAL REPORT 2002/03, *supra*. note 334, at 206-207. The U.S. total cited in the report was based on 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.

[337] The total regulatory costs for the U.S. financial regulatory agencies were approximately $6.4 billion in 2002. FEDERAL RESERVE BOARD OF GOVERNORS, ANNUAL REPORT 2002, 288 (2003); FDIC, ANNUAL REPORT 2003, 188 (2004); OCC, ANNUAL REPORT 2003, 75 and 77 (2004); OTS, FIN. REPORT 2002, 3 (2003); NCUA, ANNUAL REPORT 2002, 1 (2003), CFTC, ANNUAL REPORT 2002, 146 (2003), NAIC, 2002 INSURANCE DEPARTMENT RESOURCES REPORT, 25 (2003); SEC, 2002 ANNUAL REPORT, 180 (2003); THE CONFERENCE OF STATE BANK SUPERVISORS, A PROFILE OF STATE CHARTERED BANKING 19 ED. 2002-2003, 35 (2003); GA DEPT. OF BANKING AND FINANCE ANN. REP., 14 (2002); HI COMPLIANCE RES. FUND REP., 21 (2002); IL ANN. REP. TO GOV., 21 (2002); IN DEPT. OF FIN. INST. ANN. REP., 16 (2002); IA ANN. REP. OF SUPERINTENDENT OF BANKING, 27 (2002); MS DEPT. BANKING & CONSUMER FIN. ANN. REP., 12-14 (2002); 2002 NY BANKING DEPT ORG. & MAINT. REP., 1 (2002); SC BOARD OF FIN. INST. ANN. ACCOUNTABILITY REP., 4-5 (2002); VT ANN. REP. INS. COMMISSIONER, 10 (2002); WA DEPT. FIN. INST. ANN. REP., 2 (2002); WV ANN. REP. FIN. INST., 14, 18, 23 (2002); and UK FSA, ANNUAL REPORT 2002/03, *supra*. note 334, at 206-207. 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 19ED. 2002-2003, 35 (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 SC BOARD OF FIN. INST. ANN. ACCOUNTABILITY REP., 4-5 (2002).

The UK FSA obtained the amounts from U.S. agencies cited in its Annual Report for 2002/03 directly from the agencies. UK FSA, ANNUAL REPORT 2002/03, *supra*. note 334, at 206-207. In certain cases, it is not easy to determine how the amounts provided were calculated as they do not always represent the total expenses of the agencies in their annual reports. For example, the total expenses of the Federal Reserve Banks and the Federal Reserve Board equaled $3.4 billion in 2002, although 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, ANNUAL REPORT 2002/03, *supra*. note 334, at 206-207; FEDERAL RESERVE BOARD OF GOVERNORS, ANNUAL REPORT 2002, *supra*. note 337, at 288.

the total banking assets in the United States were 2.2 times the total banking assets in the United Kingdom and 2.3 times the total banking assets in Germany.[338] During roughly the same period, the United States, however, spent 60 times more to regulate its depository institutions than the United Kingdom spent and 236 times more than that Germany spent.[339] The United States' system costs over 27 times more to regulate banks, thrifts and credit unions than the United Kingdom and over 102 times more to regulate banks, thrifts and credit unions than Germany, after accounting for the differences in the total banking assets in each country.[340]

At least part of the reason for these cost differentials between the United States, the United Kingdom, and Germany are attributable 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

[338] UK FSA, ANNUAL REPORT 2002/03, *supra*. note 334, at 206-207. The total U.S. banking assets for 2002/03 were $9,674.6 billion. UK FSA, ANNUAL REPORT 2002/03, *supra*. note 334, at 206-207; Federal Reserve Statistical Release, *United Kingdom Historical Rates* <www.federalreserve.gov/releases/H10/Hist/dat00_uk.htm> (released dated Dec. 20, 2004).

[339] For fiscal year 2002, the total amount spent by the U.S. Federal Reserve, OCC, OTS, NCUA, FDIC, and the state banking regulators was $4,940.4 million, 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, ANNUAL REPORT 2002/03, *supra*. note 334, at 206-207; FEDERAL RESERVE BOARD OF GOVERNORS, ANNUAL REPORT 2002, *supra*. note 337, at 288; FDIC, ANNUAL REPORT 2003, *supra*. note 337, at 188; OCC, ANNUAL REPORT 2003, *supra*. note 337, at 75 and 77; OTS, FIN. REPORT 2002, *supra*. note 337, at 3; NCUA, ANNUAL REPORT 2002, *supra*. note 337, at 1, CFTC, ANNUAL REPORT 2002, *supra*. note 337, at 146, NAIC, 2002 INSURANCE DEPARTMENT RESOURCES REPORT, *supra*. note 337, at 25; SEC, 2002 ANNUAL REPORT, *supra*. note 337, at 180; THE CONFERENCE OF STATE BANK SUPERVISORS, A PROFILE OF STATE CHARTERED BANKING 19ED. 2002-2003, *supra*. note 337, at 35; and SC BOARD OF FIN. INST. ANN. ACCOUNTABILITY REP. , *supra*. note 337, 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 £1,400.2 million or $2,170.3 million. UK FSA, ANNUAL REPORT 2002/03, *supra*. note 334, at 206-207.

[340] UK FSA, ANNUAL REPORT 2002/03, *supra*. note 334, at 206-207; FEDERAL RESERVE BOARD OF GOVERNORS, ANNUAL REPORT 2002, *supra*. note 337, at 288; FDIC, ANNUAL REPORT 2003, *supra*. note 337, at 188; OCC, ANNUAL REPORT 2003, *supra*. note 337, at 75 and 77; OTS, FIN. REPORT 2002, *supra*. note 337, at 3; NCUA, ANNUAL REPORT 2002, *supra*. note 337, at 1, CFTC, ANNUAL REPORT 2002, *supra*. note 337, at 146, NAIC, 2002 INSURANCE DEPARTMENT RESOURCES REPORT, *supra*. note 337, at 25; SEC, 2002 ANNUAL REPORT, *supra*. note 337, at 180; THE CONFERENCE OF STATE BANK SUPERVISORS, A PROFILE OF STATE CHARTERED BANKING 19ED. 2002-2003, *supra*. note 337, at 35; and SC BOARD OF FIN. INST. ANN. ACCOUNTABILITY REP., *supra*. note 337, at 4-5. If the total costs of the U.S. federal banking, thrift, and credit union regulators cited in 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.

unions as the United Kingdom.[341] 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 the United Kingdom did.[342] In that same year, the United States had approximately seven times as many depository institutions as Germany.[343] If the number of depository institutions

[341] UK FSA, ANNUAL REPORT 2002/03, *supra*. note 334, at 206-207; FEDERAL RESERVE BOARD OF GOVERNORS, ANNUAL REPORT 2002, *supra*. note 337, at 288; FDIC, ANNUAL REPORT 2003, *supra*. note 337, at 188; OCC, ANNUAL REPORT 2003, *supra*. note 337, at 75 and 77; OTS, FIN. REPORT 2002, *supra*. note 337, at 3; NCUA, ANNUAL REPORT 2002, *supra*. note 337, at 1, CFTC, ANNUAL REPORT 2002, *supra*. note 337, at 146, NAIC, 2002 INSURANCE DEPARTMENT RESOURCES REPORT, *supra*. note 337, at 25; SEC, 2002 ANNUAL REPORT, *supra*. note 337, at 180; THE CONFERENCE OF STATE BANK SUPERVISORS, A PROFILE OF STATE CHARTERED BANKING 19ED. 2002-2003, *supra*. note 337, at 35; and SC BOARD OF FIN. INST. ANN. ACCOUNTABILITY REP., *supra*. note 337, at 4-5. 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, ANNUAL REPORT 2002/03, *supra*. note 334, at 206-207; FEDERAL RESERVE BOARD OF GOVERNORS, ANNUAL REPORT 2002, *supra*. note 337, at 288; FDIC, ANNUAL REPORT 2003, *supra*. note 337, at 188; OCC, ANNUAL REPORT 2003, *supra*. note 337, at 75 and 77; OTS, FIN. REPORT 2002, *supra*. note 337, at 3; NCUA, ANNUAL REPORT 2002, *supra*. note 337, at 1, CFTC, ANNUAL REPORT 2002, *supra*. note 337, at 146, NAIC, 2002 INSURANCE DEPARTMENT RESOURCES REPORT, *supra*. note 337, at 25; SEC, 2002 ANNUAL REPORT, *supra*. note 337, at 180; THE CONFERENCE OF STATE BANK SUPERVISORS, A PROFILE OF STATE CHARTERED BANKING 19ED. 2002-2003, *supra*. note 337, at 35; and SC BOARD OF FIN. INST. ANN. ACCOUNTABILITY REP., *supra*. note 337, at 4-5.

[342] UK FSA, ANNUAL REPORT 2002/03, *supra*. note 334, at 206-207; FEDERAL RESERVE BOARD OF GOVERNORS, ANNUAL REPORT 2002, *supra*. note 337, at 288; FDIC, ANNUAL REPORT 2003, *supra*. note 337, at 188; OCC, ANNUAL REPORT 2003, *supra*. note 337, at 75 and 77; OTS, FIN. REPORT 2002, *supra*. note 337, at 3; NCUA, ANNUAL REPORT 2002, *supra*. note 337, at 1, CFTC, ANNUAL REPORT 2002, *supra*. note 337, at 146, NAIC, 2002 INSURANCE DEPARTMENT RESOURCES REPORT, *supra*. note 337, at 25; SEC, 2002 ANNUAL REPORT, *supra*. note 337, at 180; THE CONFERENCE OF STATE BANK SUPERVISORS, A PROFILE OF STATE CHARTERED BANKING 19ED. 2002-2003, *supra*. note 337, at 35; and SC BOARD OF FIN. INST. ANN. ACCOUNTABILITY REP., *supra*. note 337, at 4-5. If the total costs of the U.S. federal banking and thrift regulators cited in 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 spent to regulate each of its banks and building societies in 2002/03. The amount in the sentence is based on the total budgets of the Federal Reserve, OCC, OTS, NCUA, FDIC, and the state banking regulators.

[343] UK FSA, ANNUAL REPORT 2002/03, *supra*. note 334, at 206-207; FEDERAL RESERVE BOARD OF GOVERNORS, ANNUAL REPORT 2002, *supra*. note 337, at 288; FDIC, ANNUAL REPORT 2003, *supra*. note 337, at 188; OCC, ANNUAL REPORT 2003, *supra*. note 337, at 75 and 77; OTS, FIN. REPORT 2002, *supra*. note 337, at 3; NCUA, ANNUAL REPORT 2002, *supra*. note 337, at 1, CFTC, ANNUAL REPORT 2002, *supra*. note 337, at 146, NAIC, 2002 INSURANCE DEPARTMENT RESOURCES REPORT, *supra*. note 337, at 25; SEC, 2002 ANNUAL REPORT, *supra*. note 337, at 180; THE CONFERENCE OF STATE BANK SUPERVISORS, A PROFILE OF STATE CHARTERED BANKING 19ED. 2002-2003, *supra*. note 337, at 35; and SC BOARD OF FIN. INST. ANN. ACCOUNTABILITY REP., *supra*. note 337, at 4-5. 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, ANNUAL REPORT 2002/03, *supra*. note 334, at 206-207; FEDERAL RESERVE BOARD OF GOVERNORS, ANNUAL REPORT 2002, *supra*. note 337, at 288; FDIC, ANNUAL REPORT 2003, *supra*. note 337, at 188; OCC, ANNUAL REPORT 2003, *supra*. note 337, at 75 and 77; OTS, FIN. REPORT 2002, *supra*. note 337, at 3; NCUA, ANNUAL REPORT 2002, *supra*. note 337, at 1, CFTC, ANNUAL REPORT 2002, *supra*. note 337, at 146, NAIC, 2002

being regulated in each country is taken into account, the United States spent 14 times as much as Germany.[344]

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

The disparities between the United Kingdom, 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 $977.3 billion on securities regulation (excluding state regulation costs), which was 7.6 times more than the United Kingdom and 77.6 times more than Germany. The total equity market capitalization for that period in the United States was $10,333.7 billion, which was 6.8 times more than the United Kingdom and 15.9 times more than Germany. Thus, the regulatory costs spent by the United States at the federal level and the United Kingdom to regulate the securities and futures markets are roughly comparable when the size of each country's markets are taken into account.

The reason that the United States spends significantly more than Germany does to regulate its securities and futures markets, even after taking into account the size of each country's 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 U.S. households, or 49.5 percent of all U.S. households, owned equities, either through individual stocks or through stock mutual funds.[345] In Germany, only 9.8 percent of the population owned any

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INSURANCE DEPARTMENT RESOURCES REPORT, *supra*. note 337, at 25; SEC, 2002 ANNUAL REPORT, *supra*. note 337, at 180; THE CONFERENCE OF STATE BANK SUPERVISORS, A PROFILE OF STATE CHARTERED BANKING 19ED. 2002-2003, *supra*. note 337, at 35; and SC BOARD OF FIN. INST. ANN. ACCOUNTABILITY REP., *supra*. note 337, at 4-5.

[344] UK FSA, ANNUAL REPORT 2002/03, *supra*. note 334, at 206-207; FEDERAL RESERVE BOARD OF GOVERNORS, ANNUAL REPORT 2002, *supra*. note 337, at 288; FDIC, ANNUAL REPORT 2003, *supra*. note 337, at 188; OCC, ANNUAL REPORT 2003, *supra*. note 337, at 75 and 77; OTS, FIN. REPORT 2002, *supra*. note 337, at 3; NCUA, ANNUAL REPORT 2002, *supra*. note 337, at 1, CFTC, ANNUAL REPORT 2002, *supra*. note 337, at 146; NAIC, 2002 INSURANCE DEPARTMENT RESOURCES REPORT, *supra*. note 337, at 25; SEC, 2002 ANNUAL REPORT, *supra*. note 337, at 180; THE CONFERENCE OF STATE BANK SUPERVISORS, A PROFILE OF STATE CHARTERED BANKING 19ED. 2002-2003, *supra*. note 337, at 35; and SC BOARD OF FIN. INST. ANN. ACCOUNTABILITY REP., *supra*. note 337, at 4-5.

[345] U.S. Census Bureau, Population Division, Time Series of National Population Estimates <http://www.census.gov/popest/archives/2000s/vintage_2002/NA-EST2002-01.html> (accessed Aug. 6, 2004); Investment Company Institute and Securities Industry Association, Equity Ownership in America, 2002, 1 (2002).

stocks directly in 2000, while 23.3 percent of the population of the U.K. owned stocks directly in 1996.[346] Both the United States and the United Kingdom regulate their securities markets more intensively than Germany does due to the perceived need to protect the larger number of less sophisticated investors active in the securities and futures markets in the U.S. and the U.K. than in Germany.

Insurance is one area where the duplication of efforts by the states in the United States substantially increases costs for companies and consumers. The regulatory cost disparities between the United Kingdom, 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.[347] These disparities cannot be accounted for based on the size of the insurance markets in each country. During the 2002/03 period, the total insurance premiums in the United States equaled $1,169 billion, 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.[348]

2. Inter-Agency Turf Wars in the United States Waste Funds

U.S. regulatory costs are higher than 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, like the decades long struggle between the SEC and the CFTC over securities futures, and between the federal regulators and the states have been well documented.[349] Most of these battles are fought 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 over which agency is going to regulate a particular instrument or entity then the regulatory biases of that agencies usually determine the scope and form that the final regulation takes.

[346] Laurence Boone and Natalie Girourard, *The Stock Market, the Housing Market and Consumer Behavior*, OECD ECON. STUDIES NO. 35, 175 (June 22, 2002).

[347] UK FSA, ANNUAL REPORT 2002/03, *supra*. note 334, at 206-207; NAIC, 2002 INSURANCE DEPARTMENT RESOURCES REPORT, *supra*. note 337, at 25.

[348] UK FSA, ANNUAL REPORT 2002/03, *supra*. note 334, at 206-207; NAIC, 2002 INSURANCE DEPARTMENT RESOURCES REPORT, *supra*. note 337, at 25. 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. If this amount is used, 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.

[349] See Part II above; Jerry W. Markham, *Panel I (Part 2): A Comparative Analysis of Consolidated and Functional Regulation: Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, the United Kingdom, and Japan*, 28 BROOKLYN J. INT'L L. 319, 362 (2003) (hereinafter Markham, *Super Regulator*).

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.[350]

Thus, turf wars between the states and federal government and the various federal agencies not only waste limited agency resources, but adversely affect the markets as well, although these costs to the market are much harder to quantify.

3. Compliance Costs Incurred by the Financial Services Industry Exacerbate the Problem

Simply looking at the amount that the government spends to regulate financial services underestimates the total costs to the United States 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 but the total revenues generated from fees, assessments, fines, penalties and taxes assessed by states on insurance companies totaled $12,521.7 million.[351] The 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 to comply 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 get authorization from these states for the products that it offers. If a new company wants to offer insurance in all 50 states and the District of Columbia, it must first apply for a license to operate from each one of these 51 jurisdictions, then it must seek advanced approval from each of these 51 jurisdictions for each of its products that it will

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[350] Donald E. Powell, Chairman of the Federal Deposit Insurance Corporation, Why Regulatory Restructuring? Why Now?, Exchequer Club, Press Release (Oct. 16, 2002).

[351] NAIC, 2002 INSURANCE DEPARTMENT RESOURCES REPORT, *supra*. note 337, at 22 and 25.

offer, and finally it must obtain license for each producer or agent in each state who will sell its products.[352] The costs involved in completing the applications for all of these licenses as well as paying the relevant fees are significant and create a barrier to entry, particularly for small firms. Efforts by NAIC to encourage uniformity and coordination among states have not been extremely successful.

In 2002, the total number of domestic insurers (insurers domiciled in the state in which the business is written) in the 50 states and the District of Columbia equaled 7,090, or an average of 139 domestic insurers per state.[353] The number of foreign insurers (insurers domiciled in a state different from the state in which the business is written) is larger than the number of domestic insurers in every state. On average, 1,357 foreign insurers operate in each state, which means that, on average, foreign insurers comprise a little over 90 percent of the total number of insurers in a state.[354]

If one assumes that states generally charge the same taxes, fees, assessments, fines and penalties to foreign insurers as to domestic insurers, than states raised $10.88 billion of the $12.52 billion in total revenue that states earned from taxes, fees, assessments, fines, penalties and other sources from foreign insurers.[355] 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.[356]

Compliance costs for other financial service providers are equally daunting. According to banking industry estimates, banking institutions spend approximately $25 billion annually to comply with federal and state regulations.[357]

Financial service firms will attempt to pass along to their business and consumer clients the costs that they incur to comply with the existing regulatory regime in the United States. Thus, consumers and the U.S. economy as a whole pay a large price for the current regulatory structure.

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[352] BAIR REPORT, *supra.* note 22, at 11-12.

[353] NAIC, 2002 INSURANCE DEPARTMENT RESOURCES REPORT, *supra*. note 337, at 30 and 39.

[354] *Id.*

[355] *Id.* at 25 and 39.

[356] 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. BAIR REPORT, *supra.* note 22, at 31 and 51-52. Out of 383 companies in the life insurance business that were sent the survey, 129 companies responded.

[357] Opening Statement of Chairman Spencer Bachus, Hearing of Financial Institutions and Consumer Credit Subcommittee on the Financial Services Regulatory Relief Act, H.R. 1375, 1 (March 27, 2003).

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 achieve meet these challenges? 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. It should consolidate the regulatory functions of the Federal Reserve, OCC, OTS, FDIC, SEC, CFTC, SIPC, OFHEO, and PBGC as well as the state agencies and commissions that regulate banking, securities, and insurance.[358] The merger of all of these agencies would not necessarily be done simultaneously, but could be done in a series of phases over time. The UK FSA used this stepped approached to merging different financial regulators.[359] This approach would allow the new agency time to properly integrate each group of old agencies within its framework without causing major disruptions to any segment of the financial services industry.[360]

The Federal Reserve, like the Bank of England, would retain control of its role in formulating monetary policy. Thus, the Federal Reserve would retain its ability to control the discount rate and the federal funds rate, its ability to control reserve requirements, and, through the Federal Open Market Committee, its control of the money supply by buying or selling government bonds.

Several reasons exist for maintaining the Federal Reserve as a separate agency responsible for monetary policy. First, this segregation between the regulation of financial services and the formulation of monetary policy would help both the US FSA and the Federal Reserve to each have clearly defined goals and to 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 much power within a single agency. Such a concentration of power 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 into

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[358] 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.

[359] UK FSA, ANNUAL REPORT 2003/04, 50 (2004); UK FSA ANNUAL REPORT 2002/03, *supra.* note 334 at 81 and 122; UK FSA ANNUAL REPORT 2001/02, 72 (2002).

[360] 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. GAO, MAJOR MANAGEMENT CHALLENGES AND PROGRAM RISKS: DEPARTMENT OF HOMELAND SECURITY, GAO-03-102, 3-4 (Jan. 2003).

the new agency and these units might stifle regulatory innovation as they used their dominance within the agency to impose their regulatory preferences on the 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, which means that there are fewer good models of how to create an integrated financial regulator that incorporates a country's central bank than there are good models of an integrated financial regulator that does not incorporate a country's central bank. With fewer good models, the United States may have a more difficult time anticipating and formulating ways to avoid the potential problems than it otherwise would. Fifth, the US FSA does not need the power to formulate monetary policy in order to meet the challenges facing the financial services industry that were outlined in Part III above. Because of the potential problems posed by including 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.[361]

The internal structure should be along supervisory or regulatory objectives, rather than old sectoral lines, in order to best achieve the maximum economies of scale and scope from merging the existing agencies that regulate financial services. For discussion purposes, I would propose that the internal structure of the US FSA be comprised of 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 moved with the internal reorganizations that they have undertaken following their efforts to consolidate financial service industry regulators.[362]

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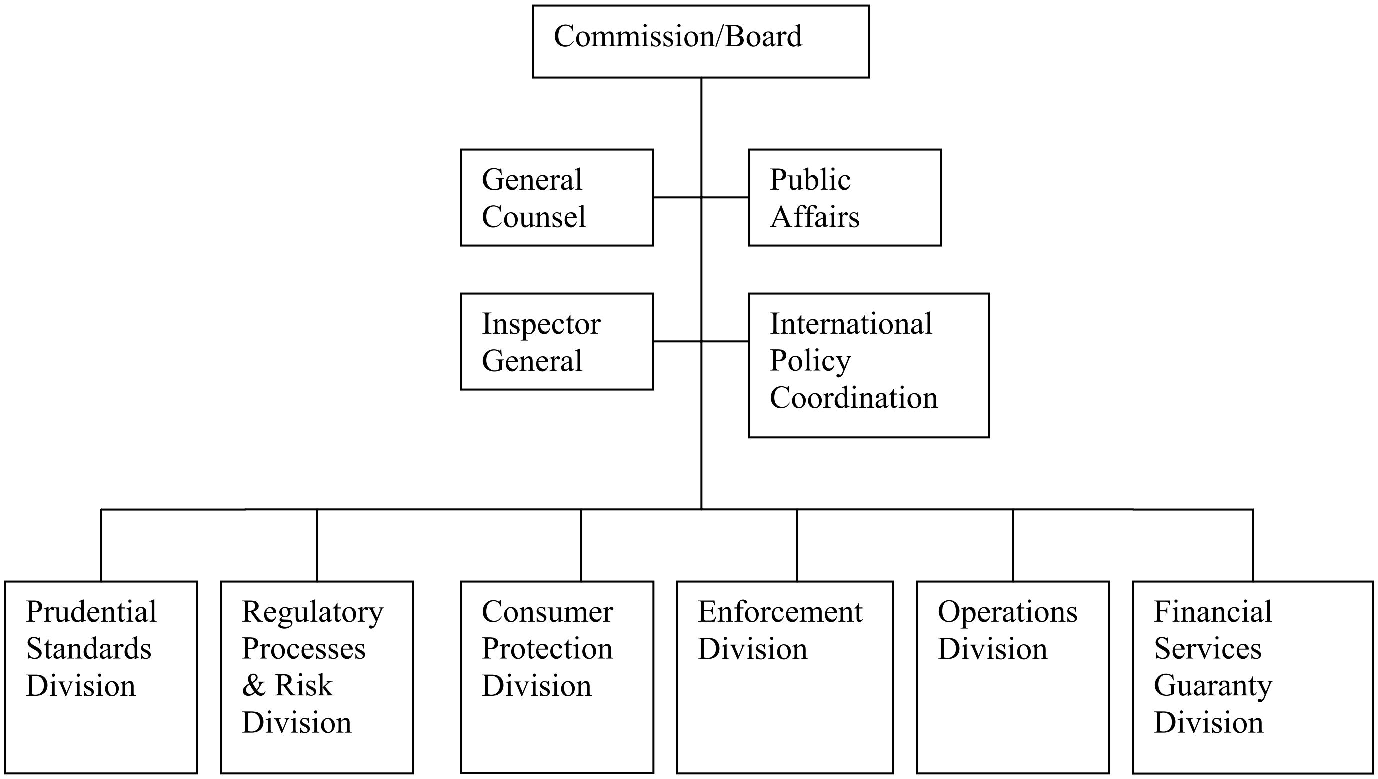
[361] For analyses of what role central banks play in financial supervision, see James R. Barth, Daniel E. Nolle, Triphon Phumiwasana and Glenn Yago, *A Cross-Country Analysis of Bank Supervisory Framework and Bank Performance*, 12 FIN. MARKETS, INSTITUTIONS & INSTRUMENTS 67 (May 2003); Donato Masciandaro, *Central Banks or Single Financial Authorities? A Political Economy Approach,* QUARDERNI DEL DIPARTIMENTO DI SCIENZE ECONOMICHE E MATEMATICO-STATISTICHE (Draft: Jan. 2004).

[362] Michigan Office of Finance & Insurance Services, Department of Labor & Economic Growth, 2000 Michigan Office of Finance & Insurance Services Annual Report (2000); Michael Taylor, *Chapter Two: Accountability and Objectives of the FSA*, BLACKSTONE'S GUIDE TO THE FINANCIAL SERVICES & MARKETS ACT 2000, MICHAEL BLAIR, ED., 27-28 (2001).

Proposed Structure for the US FSA



The Prudential Standards Division would develop the prudential standards for both the diversified and specialized financial services firms, it would conduct the examinations to determine that the firms were complying with these standards, and it 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 financial safe and reliable. In addition, it could take corrective actions to protect investors or consumers or more severe actions, such as seizure, rehabilitation or liquidation, when an entity has become insolvent.

The Regulatory Processes and Risk Division would regulate financial advice and products, regulate 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 engendered in consumers by the myriad of existing hotlines and websites for 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 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 fraud and for 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 also would 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.[363] 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 to compensate the victims of such crimes and would not become part of the general revenues for the federal or state governments. Such a fund was established at the federal level for victims of securities fraud under the Sarbanes-Oxley Act of 2002.[364]

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 result in cost savings by achieving economies of scale when the back office operations of the existing regulatory agencies are consolidated.

The Financial Services Guaranty Division would fulfill the functions previously performed by the FDIC, the SIPC and the PBGC as well as the functions performed by the state insurance guaranty funds. It would act as the last resort for customers or investors of financial services firms that are members of the funds managed by the division. The division would administer a deposit insurance fund that would insure deposits in depository institutions for up to $100,000. It would administer a securities insurance fund that would work to

[363] Mark Sargent, *A Future for Blue Sky Law*, 62 U. CIN. L. REV. 471, 504-505 (Fall 1993).

[364] Pub. L. No. 102-204 (2002).

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 to the investor. It would also administer a fund to insure pension benefits against insolvency and another fund to cover the claims of policyholders and claimants of insurance companies that have become insolvent.

The US FSA should be managed by a board of directors led by a chairman. The number of directors should be large enough to represent a range of opinions and interests but not so large as to be unwieldy. The number of directors for federal agencies that regulate some aspect of the financial services industry range from three to seven. A board comprised of fewer than five directors probably would not provide the diversity of views necessary to consider when determining new regulations for financial products and services. A board comprised of more than 16 directors probably would be too unwieldy 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 is structured along the lines of the Federal Reserve's board with 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 in order to keep the board non-partisan. So only four of the seven directors of the US FSA may come from the same political party for purposes of this article. As with most federal financial service regulators, all of the directors would be nominated by the President but must be approved by the Senate before they can assume their positions.

In addition, like the SEC but unlike the Federal Reserve, each director will have a small staff at their disposal to help them effectively oversee the operations of the agency. All of the staff of the Federal Reserve work primarily for the chairman and other directors generally are only allocated a secretary and perhaps one other aide.[365] As a result, other directors at the Federal Reserve are constrained in their ability to stake out different positions from those of the chairman. By providing the directors of the US FSA with staffs, 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 that are to be considered for approval by the directors would be required to submit them for review and comment by each of the other divisions, except for the Operations Division. The other divisions would not have a veto right over the proposed regulations. Nevertheless, the comments of the other divisions would be provided to the directors for their consideration and would become part of the public record. Regulations only would become final after they have been approved by a majority vote of the US FSA's board of directors.

[365] MARTIN MAYER, THE FED 304 (Plume: 2001).

The new US Financial Services Agency would be funded out of the fees that it charges the institutions that it regulates, just as the Federal Reserve does and as the UK FSA does. Most U.S. financial regulatory agencies and the UK FSA generate more in fees than they need to fund their operations.[366]

B. *Accountability Safeguards for the US FSA*

Obviously the size and powers of the US FSA raise concerns about how to keep it accountable and responsive to the needs of the American businesses, consumers, and investors.

The US FSA would be accountable to Congress. It would be required to file an annual report with Congress describing its activities over the past year and its plans for the future. It also would be required to make periodic reports to the House Committee on Financial Services and the Senate Committee on Banking, Housing and Urban Affairs and to testify before other Congressional committees when appropriate. In some respects this would make its activities more transparent than some state agencies, which do not produce reports detailing their actions and expenditures.

The US FSA should establish at least two advisory groups, one comprised of representatives for consumers and one comprised of representatives from the financial services firms, which would offer advice to the US FSA on pending regulatory matters as well as 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 having offices spread throughout the United States. The US FSA would have specialists in each office to conduct examinations of financial institutions and to investigate violations and consumer complaints for that region. These offices would allow the US FSA to be more responsive to the concerns of financial firms and consumers across the United States than it would be if it solely operated out of Washington, D.C.

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

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[366] UK FSA, ANNUAL REPORT 2002/03 (2003); FEDERAL RESERVE BOARD OF GOVERNORS, ANNUAL REPORT 2002 (2003); FDIC, ANNUAL REPORT 2003 (2004); OCC, ANNUAL REPORT 2003 (2004); OTS, FIN. REPORT 2002 (2003); NCUA, ANNUAL REPORT 2002 (2003), CFTC, ANNUAL REPORT 2002 (2003), NAIC, 2002 INSURANCE DEPARTMENT RESOURCES REPORT (2003); SEC, 2002 ANNUAL REPORT (2003); THE CONFERENCE OF STATE BANK SUPERVISORS, A PROFILE OF STATE CHARTERED BANKING 19ED. 2002-2003 (2003).

V. Advantages of a Single Financial Regulator

The advantages of the US FSA all derive from the fact that it would enable the United States to address in a more constructive fashion each of the major challenges facing the financial services industry. These benefits would not be achievable to the same extent under the present regime nor under the other 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 FFIEC and the other ad hoc consultations 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 to develop regulations dealing with financial conglomerates. The US FSA also would cover all financial services sectors rather than just the banking regulators as FFIEC does. Because 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 expanding FFIEC to include more state and federal regulators like the SEC and all 50 state insurance commissioners. It also would be more effective than the functional consolidation option, twin peaks option and financial conglomerate agency option, which were proposed by the GAO and which would still require multiple agencies to act cooperatively in order to coordinate 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 the existing regulations and attempt to harmonize them so that they are more consistent and uniform in their application. The UK FSA was able to reduce the number of regulations governing financial service firms from the number of regulations that had existed prior to its creation.[367] 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.[368]

[367] UK FSA, HANDBOOK DEVELOPMENT, NO. 58, 2 (Dec. 2004).
[368] *Id.*

The United States should be able to do so as well, particularly when one considers the fact that a single, federal regulator could end 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.[369] The United States would also benefit from the rationalization of regulations that affect other financial products and companies as well. Nevertheless, this rationalization process will not happen over night, but probably will require several years to complete.[370]

In addition, 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 to investigate whether new products or firms ought to be regulated and the appropriate type of regulation needed than under the existing system, in which agencies shirk responsibility by arguing that the product or firm fell outside of their jurisdiction. This debate over hybrid products likely would continue if any of the other three options proposed by the GAO was implemented.

The US FSA also might be more willing to consider innovative ways of dealing with problems arising within the financial services area, like stock market bubbles. The consolidation of the different agencies into the US FSA will expose regulators to different regulatory methods. As noted in Part III, the narrowly focused existing agencies tend to rely on a limited set of regulatory tools, which are products of each agency's history and regulatory priorities. As a result, they are not very innovative when considering possible regulatory approaches for new problems. Exposure to other regulatory methods may result in synergies that lead to more innovative ways of dealing with market failures or other problems. The functional consolidation option and the financial conglomerate agency option would not offer this benefit, but would maintain the current balkanized regulatory preferences that exist within the existing regulators for certain segments of the financial markets. 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

[369] BAIR REPORT, *supra.* note 22, at i-ii.

[370] JOSÉ DE LUNA MARTINEZ AND THOMAS A. ROSE, INTERNATIONAL SURVEY OF INTEGRATED FINANCIAL SECTOR SUPERVISION 13 (The World Bank, Financial Sector Operations and Policy Department, Policy Research Working Paper 3096, July 2003). The Martinez 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. *Id.* at 31. Martinez 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. *Id.* at 31-32.

regulatory backgrounds together. 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.

In addition, given the size and breadth of the US FSA, the head of the US FSA would be more likely to have the same standing as the current Federal Reserve chairman to attempt to use moral suasion to talk the market down in the event of another financial bubble like the market bubble that developed in the stock market in the late 1990s than the chairman of the SEC or one of the smaller state regulatory agencies would have. None of the other options proposed by the GAO would create an agency that would have the same stature and moral authority that 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 able 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. Regulators may view the importance of the problem differently based on the objectives of their agencies and, thus, may be less willing to cooperate and focus on a problem than 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, and to develop a plan to harmonize them so that all firms operate on a level playing field. In addition, 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 the existing regulators to suggest ways to make the rules more enforceable than the current rules.

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 together to devise regulations for financial conglomerates.

While it is certainly easier to coordinate three agencies than it is to coordinate over 115 agencies, turf wars could still arise amongst these agencies, which would undermine their effectiveness in developing regulations for financial conglomerates. 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 agency to regulate financial conglomerates, but would leave the existing regulators in place. As a result, problems may arise regarding which entities are classified as financial conglomerates and fall within the scope of the new agency as opposed to being regulated by one of the existing financial regulators and how the financial conglomerate agency will coordinate the regulations for financial conglomerates with the regulations issued by the existing financial regulators. The US FSA would avoid these problems. To the extent that similar issues may arise between units within the US FSA, the US FSA Board of Directors would be able to resolve them more quickly and efficiently than any process of inter-agency negotiation or litigation could. As a result, the US FSA would be a better regulator for 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 to save failing institutions. The Federal Reserve may have concerns about the damage to its reputation that would be caused by the failure of a bank under its supervision. Thus, the Federal Reserve is more likely to attempt to save a trouble banked that it is supervising than it is to save a bank that is 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 in that manner. As noted in Part II above, the current structure permits some financial conglomerates to be regulated by different state and federal regulators on a consolidated basis, while other financial conglomerates are not regulated at all on a consolidated basis. The US FSA would be solely responsible for regulating financial conglomerates and could be held to account if it failed to do so properly.

Third, because the US FSA would be a new agency, strong prohibitions could be enacted when it is created to deny it the power to bail out large financial conglomerates. This would not prevent Congress from moving to rescue large, failed institutions, but such instances are likely to be rarer than agency sponsored rescues because of the difficulty in obtaining the requisite majority in Congress to pass a law authorizing such a rescue.

The US FSA would be better able to deal with the "too big to fail" problem than the other options proposed by the GAO because none of the other options makes a single agency accountable if a financial conglomerate fails. Responsibility if a financial conglomerate fails would be divided amongst 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, which 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 have a unified position in international negotiations, which would avoid embarrassing situations, as occurred during the Basel II negotiations, of having different regulators from the same country arguing for different proposals. To the extent that divisions within the US FSA might have different views on what the U.S. position should be, those differences could be discussed and a unified position negotiated within the agency before the agency undertakes negotiations with other countries.

In addition, the US FSA would 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 take. 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 to be derived from globalization.

These 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 the US FSA does.

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

Several factors either mitigate or eliminate the problem of agency capture as a concern when forming a U.S. Financial Services Agency. First, as noted above, agency capture occurs less frequently in agencies that regulate several competing interest groups.[371] An agency, like the US FSA, that regulates a wide range of businesses and sectors is less likely to be captured because the interests

[371] See Part III, D, 1. Current Specialized Agencies are Prone to Capture, *supra*.

of the different businesses and sectors generally will be at odds with one another and will in part cancel each other out when competing to shape an agency's position on an issue.[372] 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 regulatory goals, such as prudential concerns, rather than industry segments, such as insurance.

The US FSA also is not likely to be captured by financial conglomerates. 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.[373] In the finance literature, the conglomeration hypothesis states that conglomerates will maximize value by employing a range of businesses that can achieve cost scope economies by sharing certain inputs or can achieve revenue scope economies by being able to charge clients more for the convenience of providing "one-stop shopping".[374] The strategic focus hypothesis states that firms that specialize by focusing on core businesses and core competencies will maximize value.[375] If only the conglomeration hypothesis is correct, then firms would tend over time to move toward becoming conglomerates and if only the strategic focus hypothesis is correct then firms would tend over time to become more specialized.[376] The reason for these trends is that the other strategies would be inefficient and the firms would be compelled by market forces to either change their strategies or go out of business.[377]

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[372] California recently decided to consolidate many of its agencies in order to take advantage of the reduction or elimination of the agency capture problem. CALIFORNIA PERFORMANCE REVIEW REPORT, released Aug. 3, 2004, <http://report.cpr.ca.gov/cprrpt/preschg/ebo.htm> (accessed Dec. 29, 2004); John M. Broder, *Plan Would Consolidate California Agencies*, N.Y. TIMES (Aug. 4, 2004).

[373] Allen N. Berger, J. David Cummins, Mary A. Weiss, and Hongmin Zi, *Conglomeration versus Strategic Focus: Evidence from the Insurance Industry*, FINANCIAL INSTITUTIONS CENTER, THE WHARTON SCHOOL, UNIVERSITY OF PENNSYLVANIA, WORKING PAPER 99-29-B, 28 (March 2000).

[374] Berger, et.al., *supra.* note 373 at 1; D.J. Teece, *Economies of Scope and the Scope of Enterprise*, 1 J. OF ECON. BEHAVIOR & ORGANIZATION, 233-247 (1980); R.J. Herring and A.M. Santomero, *The Corporate Structure of Financial Conglomerates*, 4 J. OF FIN. SERVICES RESEARCH , 471-497 (1990); J.G. Gallo, V.P. Apilado and J.W. Kolari, *Commercial Bank Mutual Fund Activities: Implications for Bank Risk and Profitability*, 20 J. OF BANKING & FIN. 1775-1791 (1996); and C.W. Calomiris, *Universal Banking 'American Style'*, 154 J. OF INST. & THEORETICAL ECON. 44-60 (1998).

[375] Berger, et. al., *supra* note 373 at 2; M.C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers*, 76 AM. ECON. R. 76 323-329 (1986); Y. Amihud and B. Lev, *Risk Reduction As a Managerial Motive for Conglomerate Mergers*, 12 BELL J. OF ECON. 605-617 (1981); and M. Meyer, P. Milgrom and J. Roberts, *Organizational Prospects, Influence Costs, and Ownership Changes*, 1 J. of Econ. & Management Strategy 9-35 (1992).

[376] Berger, et. al., *supra* note 373 at 2.

[377] *Id.*.

Research on the 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 coexisted with firms that operated in both insurance lines, which are referred to as joint producers.[378] The insurance sector's profit scope economies, which take into account both costs and revenues, suggest the conglomerates and specialist firms will coexist because the conglomeration hypothesis is valid for large joint producers, those that emphasize personal lines of business, and those that use vertically integrated distribution systems while the specialization hypothesis is valid for small and medium-sized insurers, those that emphasize commercial lines, and those that use non-integrated distribution systems.[379] As a result, the market forces in the insurance sector will encourage the continued coexistence of both joint producers and specialized firms.

Second, 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.[380] Most countries that have created a single financial regulator have allowed its budget to come out of the fees that it charges.[381] Thus, such agencies operate like the Federal Reserve, which has control over its budget and is not held hostage to the budgetary constraints that Congress can impose. Research indicates that the Federal Reserve has been less likely to be captured by the banks, bank holding companies, and financial holding companies that it regulates than other U.S. agencies, like the SEC, which have their budgets set by Congress or a state legislature.[382]

The functional consolidation option and the financial conglomerate agency options both create agencies that are more likely to be captured by certain segments within the financial services industry than the US FSA would be. The twin peaks option offers similar benefits to the US FSA because it creates two agencies that would cover 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 to track people and

[378] *Id*. at 28

[379] *Id*. at 27.

[380] Croley, *supra*. note 273, at 15-16; Ramirez, *supra*. note 101 at 541-542.

[381] UK FSA, Who we are/How we are funded <http://www.fsa.gov.uk/funding/> (accessed Dec. 31, 2004).

[382] Ramirez, *supra*. note 101 at 541-542.

firms who have violated financial laws and regulations, the US FSA would be more effective in deterring financial crimes and enforcing the laws and regulations, resulting in better protection for consumers against such crimes. Fourth, by creating the Consumer Protection Division within the US FSA, the agency is more likely to take into account consumer protection concerns than 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 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 ombudsman that would act to ensure that consumers are heard. In addition, states would continue to be able to protect their citizens by enforcing the federal laws and regulations, but they would no longer be able to disrupt the financial markets by legislating conflicting laws and regulations.[383]

The experience of the UK FSA provides some 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 2004 that some practitioners were concerned that the UK FSA was too focused on protecting consumers.[384]

Under both the functional consolidation option and the financial conglomerate agency option, firms would still be able to play one regulator off against each other. Under the functional consolidation option, the opportunities to do so would be substantially reduced, but they would still exist. Under the financial conglomerate agency option, all of the existing regulators would continue to operate and so this problem would continue. The twin peaks option would come close to achieving the benefits of the US FSA because it would create two agencies which would have significantly different regulatory goals, one focusing on prudential issues and the other focusing on market issues. As a result, the opportunities to play these two agencies off against each other would be very few.

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[383] 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 and Macey, *supra*. note 310 at 693. For example, the anti-branching state laws allowed local state regulators to protect local bank monopolies.

[384] THE FINANCIAL SERVICES PRACTITIONER PANEL, THIRD SURVEY OF THE FSA'S REGULATORY PERFORMANCE (Dec. 2004).

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; the first company seeking to offer such a product would only have to submit one application to the US FSA rather than contacting different 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 noted in Part III, E, 2 above, existing regulators tend to have a preferred regulatory method and do not give adequate consideration to other methods that may be more beneficial. 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 each case, these regulators would expose each other to different ways of viewing prudential or conduct of business regulatory challenges. In addition, the US FSA would encourage cooperation and dialogue between all of its divisions, which would enhance the potential for regulatory synergies and innovative regulatory processes to emerge.

The potential for these types of synergies is displayed in the regulatory proposals that have been 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, who was 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.[385] Her suggestion was not the first time that such disclosure had been recommended.[386] Nevertheless, Ms. Glassman acknowledged that her willingness to consider such disclosure was the product of her move out of one agency, the Federal Reserve, to another agency, the SEC.[387] The SEC has

[385] Rob Blackwell, *Camels Score Disclosure Back in Play*, THE AMERICAN BANKER 1 (June 11, 2002); Nader, *The Secret World of Banking, supra.* note 278.

[386] Both former FDIC Chairman William Isaac and former FDIC Chairman L. William Seidman had supported disclosing CAMELS scores in the 1980s. Blackwell, *supra*. note 385 at 1.

[387] Blackwell, *supra*. note 385. The banking industry representatives strongly oppose CAMELS scores being disclosed on the grounds that such scores are "a judgment call" and could have a "distortional effect" on banks' operations. Blackwell, *supra*. note 385. 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 385.

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 a different perspective regarding financial regulations than the Federal Reserve and is not as beholden to the banks as the Federal Reserve.

In all but the financial conglomerate agency option, the initial approval process for products and services likely would be done more cheaply and faster than under the current regime. It would not be faster under the financial conglomerate agency option because that option preserves all of the existing regulators and merely adds a new agency to deal with financial conglomerates to the mix. Thus, the approval process for products and services likely would remain relatively unchanged under that option.

US FSA, however, would be better at encouraging regulatory innovations than the functional consolidation option and the financial conglomerate agency option because it would expose regulators to differ types of regulation by bringing together regulators with different regulatory preferences to address the relevant risks rather than trying to devise regulations based on the entity or the product as these two other options would do. The twin peaks options might have similar benefits to 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 options might be marginally less innovative than the US FSA because the regulators dealing with different types of risks might interact with one another less frequently when they are in two separate agencies rather than one agency. As a result, fewer synergies and correspondingly fewer innovations may develop when financial regulators operate out of two agencies rather than one.

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. The local offices and the national call center would make it easy for consumers to know what agency to contact and to get help immediately.

The US FSA could draw on the experiences of the OCC and other regulators that have operated similar centers to ensure that the call center is up and running quickly. The OCC currently operates a consumer complaint center in Houston, Texas, in order to handle complaints about national banks. The center has 40 staff members responding to approximately 78,000 complaints annually.[388] The center returned about $6 million in fees to consumers in 2002.[389]

with greater information about the bank. Blackwell, *supra*. note 385; Nader, *The Secret World of Banking*, *supra*. note 278.

388 Blackwell, *supra*. note 385.

389 *Id*.

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 adding another agency on top of the more than 115 existing agencies. The functional consolidation option would be better than the existing situation but would not be as optimal as the US FSA. It would create three agencies 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 also would be better than the existing regime but not as good as the US FSA, because consumers and investors may be uncertain what concerns or issues to raise with the agency that focuses on safety and soundness issues and what concerns or issues to raise with the agency that focuses on conduct-of-business issues. In the case of the US FSA, consumers and investors would not have to sort out with what agency to raise issues and complaints.

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

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

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, product approvals for the same product by different state and federal agencies, and examinations by different agencies. Second, economies of scale would allow the US FSA to perform the same functions with fewer people than are currently employed by all of the state and federal agencies combined. The US FSA could also reassign agency officials to where the needs are the greatest more easily than the individual smaller agencies can. Internal services that are common to all of the state and federal agencies, such as human resources, purchasing and accounting, could also achieve cost savings by achieving economies of scale and reducing duplication of efforts.[390]

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

[390] California Performance Review Report, released Aug. 3, 2004, <http://report.cpr.ca.gov/cprrpt/preschg/ebo.htm> (accessed Dec. 29, 2004). 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.

regulatory bodies.[391] The UK FSA's budget decreased in real terms during this period, despite the fact that it was incurring transitional costs connected with the consolidation of its financial service regulators into a single agency.[392] In addition, by consolidating 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.[393] If one factors in inflation for this period, Germany saved over 8%. In addition, the State of Illinois was able to save 14% in 2004 over the amount it spent in 2003 to regulate financial services by consolidating its separate banking, securities and insurance regulators to form the Department of Financial and Professional Regulation in 2004.[394] While Michigan's regulatory expenses increased initially in 2001 and 2002 after creating its single financial services regulatory agency, they decreased substantially in 2003.[395] In 2003, Michigan spent 14% less than it spent in 1999 to regulate financial services.[396]

The United States might expect that its savings would probably mirror or exceed those realized by Illinois and Michigan rather than those of the United Kingdom or Germany, because the United States' regulatory regime is considerably more costly than those of the United Kingdom and Germany. As noted in Part III, F. above, the United States spends 12 times more than the United Kingdom and over 86 times more than Germany to regulate financial services.[397] While some of these costs may be due to the more intensive regulation of financial services undertaken by the United States as compared to Germany and the United Kingdom, some of these higher costs of the U.S. regulatory regime are due to the jurisdictional overlap between state and federal agencies. These regulatory costs have a ripple effect throughout the financial services industry as the fees, assessments and taxes raised to pay for the regulatory regimes generally

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[391] UK FINANCIAL SERVICES AUTHORITY, PLAN & BUDGET 2001/2, 45 (2001); Clive Briault, *Revisiting the Rationale for a Single National Financial Services Regulator*, FSA OCCASIONAL PAPER SERIES NO. 16, 16 (Feb. 2002).

[392] UK FINANCIAL SERVICES AUTHORITY, PLAN & BUDGET 2001/2, *supra.* note **Error! Bookmark not defined.**; Briault, *supra.* note **Error! Bookmark not defined.**.

[393] BUNDESANSTALT FÜR FINANZDIENSTLEISTUNGSAUFSICHT (BAFIN), GESCHÄFTSBERICHT 2001 DES BUNDESAUFSICHTSAMTES FÜR DAS KREDITWESEN (BAKRED) 70 (Nov. 2002); BUNDESAUFSICHTSAMT FÜR DEN WERTPAPIERHANDEL (BAWE), JAHRESBERICHT 2001, 53 (2002); BaFin, GESCHÄFTSBERICHT 2001 DES BUNDESAUFSICHTSAMTES FÜR DAS VERSICHERUNGSWESEN (BAV) TEIL A, 91 (Nov. 2002); BAFIN ANNUAL REPORT 2003, PART A, 217 (June 2004). These annual reports may be found at www.bafin.de.

[394] ILLINOIS DEPARTMENT OF FINANCIAL AND PROFESSIONAL REGULATION, PRESS RELEASE, *Five Agency Merger Will Net $14 million in Savings* (Feb. 18, 2004) <www.idfpr.com/overview.asp>.

[395] 2001 MICHIGAN OFFICE OF FINANCIAL & INSURANCE SERVICES ANNUAL REPORT 10 (2002); 2002 MICHIGAN OFFICE OF FINANCIAL & INSURANCE SERVICES ANNUAL REPORT 11 (2003).

[396] 1999 MICHIGAN DEPARTMENT OF CONSUMER & INDUSTRY SERVICES, FINANCIAL INSTITUTIONS BUREAU ANNUAL REPORT 55 (2000); 1999 MICHIGAN INSURANCE BUREAU ANNUAL REPORT 25 (2000); 2003 MICHIGAN OFFICE OF FINANCIAL & INSURANCE SERVICES ANNUAL REPORT 11 (2004).

[397] See Part III, F and accompanying footnotes *supra*.

far exceed the actual budgets of the regulatory agencies and those expenses are passed along to financial services customers.

These cost savings would not result if the financial conglomerate agency option. In fact, costs would probably increase because a new agency would be created while all of the other agencies would continue to operate. The functional consolidation option and the twin peaks options would achieve some the cost savings that the US FSA would achieve but they would not completely achieve the economies of scale that the US FSA could achieve. For example, the three agencies under the functional consolidation option or the two agencies under the twin peaks option would not be able to reallocate staff to needed areas to the same 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:[398]

- Any regulatory consolidation may reduce regulatory competition and experimentation;
- A single regulator would be very large and could be 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;
- A single regulator may lose or fail to develop staff with specialized knowledge related to large and 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.

All of these problems either can be avoided or can be managed to reduce any negative effects. None of them 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. above, whether regulatory competition exists and is desirable has been much debated.[399] Nevertheless, the reduction in

[398] GAO Financial Regulation Report, *supra.* note 8, at 130-131; Martinez and Rose, *supra*. note 370 at 27-31.

[399] Regulatory competition may take several forms. Regulatory competition may occur in the area of enacting new laws or regulations. Another area is the enforcement of existing laws. Articles that support the desirability of regulatory competition include the following, among others: Bair Report, *supra.* note 22, at 51; Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 Yale L.J. 2359 (1998); and Rosen, *supra.* note 294 at 967

regulatory competition from the creation of the US FSA will not produce any significant harm, while it will have 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 the states will act when the federal government fails to do so. 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 in order to win business for other elements of their business, 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.[400] Critics of the SEC claim that it failed to bring these cases because it was captured by the industry.[401]

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 financial laws.

Second, as admirable as Spitzer's actions are, he is something of anomaly. For over 70 years prior to Spitzer, the New York attorneys general did not aggressively use the Martin Act to prosecute fraud within the financial services industry.[402] Spitzer's use of the Martin Act has been criticized as political

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(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 310 at 677 (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); and Whalen, *supra*. note 299.

[400] Nicholas Thompson, *The Sword of Spitzer*, LEGAL AFFAIRS 53-54 (May/June 2004).

[401] *Id.* at 54 (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).

[402] *Id* at 51-52 (noting that the Martin Act was generally not used by the New York attorneys general for over 70 years during the period from the end of Attorney General Albert

opportunism rather than a concerted effort to have New York State remain an effective securities regulator.[403]

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.[404] In addition, state budget constraints have resulted in the understaffing of some state banking, securities and insurance staffs, which makes it more difficult for them to operate as effective regulators.[405]

With regard 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 the settlements even though high fees charged by funds had little or no relation to the market timing and late trading practices for which Spitzer had brought suits against them.[406] Regulators in all 50 states imposing duplicative or inconsistent regulations 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, while expressing his hope that Congress would not preempt state actions during the next three years, which corresponds to the remainder of his term as Attorney General.[407]

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 for this view was articulated by Henry N. Butler and Jonathan R. Macey in their article, The Myth of Competition in the Dual Banking System, 73 Cornell L. Rev. 677 (May, 1988). They argue that the dual banking system does not really lead to regulatory competition because of several factors, including (1) the federal government under the power of the Supremacy Clause exercises its powers of preemption to prevent any significant loss of market share or regulatory control to the states, (2) both state and federal banks must obtain FDIC insurance in order to remain competitive and are subject to the regulations set forth by the FDIC, and (3) 34 states have adopted laws that

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Ottinger's term in 1928 until 2001 when Attorney General Eliot Spitzer decided to use the Martin Act against Merrill Lynch).

[403] *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.")

[404] Joel Seligman, *Multiple Regulators: Where Are We? How did We Get Here?* in CLIFFORD E. KIRSCH, ED., THE FINANCIAL SERVICES REVOLUTION 471 (Irwin Professional Publishing: 1997).

[405] *Id.*

[406] *Id.* at 54.

[407] *Id.* at 54 (in the same speech, Spitzer noted, "In three more years, I'll move on to other things.").

automatically impose the regulations of national banks on state banks in certain circumstances.[408] Butler and Macey also concluded that it was in both state and federal bank regulators interest to engage in cooperation rather than competition in order to enhance their relative power and to extract the maximum rents from the banking industry.[409] Butler and Macey characterize the existing system of state and federal bank regulators as a regulatory cartel.[410]

A similar case has been made in the context of insurance. Proponents of the existing system have argued that it allows regulators to experiment with different regulatory frameworks. They argue that this experimentation results in the best type of regulations being found and then leading to all states adopting the best practices. In reality, this type of regulatory competition rarely occurs.[411] 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.[412] These types of regulation, however, generally receive little attention from either the states' executive or legislative branches despite the fact that the current regulations result in significantly more losses for government sponsored guaranty associations from property-liability failures than for other financial institutions.[413]

According to a recent empirical study, the average cost to the guaranty associations for property-liability insurers insolvencies during the period 1986 to 1999 was $1.10 per $1 of pre-insolvency assets, which is three to five times as much as the losses realized from a typical bank failure.[414] The study determined that one of the main factors resulting in 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.[415] 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 and all three reports were

[408] Butler and Macey, *supra*. note 310 at 694-699; ANN GRAHAM, BANKING LAW §4.03[10] (LexisNexis Matthew Bender: 2004).

[409] Butler and Macey, *supra*. note 310 at 691-693.

[410] *Id.* at 690.

[411] MARTIN F. GRACE, ROBERT W. KLEIN, AND RICHARD D. PHILLIPS, INSURANCE COMPANY FAILURES: WHY DO THEY COST SO MUCH? 31 (The Center for Risk Management and Insurance Research, Georgia State University, Working Paper No. 03-1, Oct. 30, 2003).

[412] *Id.*

[413] *Id.* at 31.

[414] *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 1980s 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).

[415] *Id.* at 29 and 31.

highly critical of the existing departmental practices and called for reform. Nevertheless, none of these states instituted major structural reforms.[416]

3. The Benefits of Regulatory Competition Have Not Persuaded Other Countries to Recreate the Multitude of Regulators in the United States

In the past 20 years, at least 50 countries have either created a single financial services regulator, which is also known as an integrated regulator, or have created a semi-integrated regulatory structure for financial services by consolidating the regulation of at least two of the sectors, either banking and securities or banking and insurance or securities and insurance, into one agency.[417] 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. comprise three of four leading insurance countries in 2001 in terms of direct premiums written.[418] These countries also contain three of the largest securities markets in the world, the Nikkei, Deutsche Borse, and the London Stock Exchange. In addition, Japanese, German and British banks comprise 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:

[416] *Id.* at 31.

[417] A number of articles have compared the supervisory regimes of different countries that have adopted a single banking or financial services supervisory agency model, including: Richard K. Abrams and Michael W. Taylor, *Issues in the Unification of Financial Sector Supervision*, IMF WORKING PAPER WP/00/213 (Dec. 2003); James R. Barth, Daniel E. Nolle, Triphon Phumiwasana and Glenn Yago, *A Cross-Country Analysis of Bank Supervisory Framework and Bank Performance*, 12 FIN. MARKETS, INSTITUTIONS & 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 BROOKLYN J. INT'L L. 257 (2003); Markham, *Super Regulator, supra.* note 349, at 319; Martínez and Rose, *supra*. note370; and Marc Quintyn and Michael W. Taylor, *Regulatory and Supervisory Independence and Financial Stability*, IMF WORKING PAPER WP/02/46 (March 2002); HUNGARIAN FINANCIAL SUPERVISORY AUTHORITY, ANNUAL REPORT 2001, 3 (Budapest, Hungary: May 2002); Central Bank and Financial Services Authority of Ireland Act 2003, No. 12 of 2003. The GDP of these countries in 2002 totaled approximately $15,356 billion, or 31.3 percent of the world's GDP. CENTRAL INTELLIGENCE AGENCY, THE WORLD FACTBOOK, Rank Order – GDP <www.cia.gov/cia/publications/factbook/rankorder/2001rank.html> (accessed Aug. 1, 2004).

[418] INSURANCE INFORMATION INSTITUTE, INTERNATIONAL INSURANCE FACT BOOK 2003 <www.internationalinsurance.org/international/overview/> (accessed Aug. 28, 2004).

Countries with Either an Integrated or Semi-Integrated Financial Services Agency as of March 1, 2005[419]

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)	Dominican Republic	Australia	Bolivia
Bahrain (2002)	Finland	Belgium	Bulgaria
Cayman Islands (1997)	Luxembourg	Canada	Chile
Denmark (1988)	Mexico	Colombia	Egypt
Estonia (2002)	Switzerland	Ecuador	Jamaica
Germany (2002)	Uruguay	El Salvador	Mauritius
Gibraltar (1991)		Guatemala	Slovakia
Hungary (2000)		Kazakhstan	South Africa
Iceland (2001)		Malaysia	Ukraine
Ireland (2003)		Peru	
Japan (2000)		Saudi Arabia	
Kazakhstan (2004)		Venezuela	
Latvia (2001)			
Maldives (1999)			
Malta (2002)			
Nicaragua			
Norway (1986)			
Singapore (1984)			
South Korea (1998)			
Sweden (1991)			
Taiwan (2004)			
UAE			
UK (1997)			

[419] Martínez and Rose, *supra*. note 370 at 13; Barth, et.al., *supra*. note 417 at 48-50; CENTRAL BANK AND FINANCIAL SERVICES AUTHORITY OF IRELAND ACT 2003, No. 12 of 2003 Part IIIA, Ch. I, par. 33B (2003); Bahrain Monetary Agency, *Financial Sector Overview*, <www.bma.gov.bh/cms/index.jsp?action=article&ID=16> (accessed Aug. 18, 2004); Bulgaria Financial Supervision Commission, *About the Commission* <www.fsc.bg/e_fsc_page.asp?v=2> (accessed Aug. 18, 2004); Cayman Island Monetary Authority, *About Us – Some Events in the History of the Cayman Islands* <www.cimoney.com.ky/templates/HTMLPage/defaultdisplay.asp?text_id=HTMLPage50644&button=1> (accessed Aug. 18, 2004); *Dominica to Set Up a Single Financial Regulatory Body*, FIN. TIMES (Dec. 31, 2003); Finland Ministry of Finance, Stability and Supervision

Several other countries are considering or have considered creating a single financial supervisor. Countries considering creating a single financial supervisory agency include Russia, Bulgaria, Indonesia, Italy, Mexico, Philippines, Poland, Slovakia, Slovenia, South Africa, the Ukraine[420] and Finland.[421] 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.[422]

The actions of all of these nations illustrate that the trend internationally is towards 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 agreed on what powers to give this agency.[423] This suggests that, in the marketplace of ideas, other nations are not convinced that the benefits of regulatory competition out weigh 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 that exist in other countries, like the United Kingdom.[424] The GAO noted that the UK FSA only

<www.vm.fi/vm/liston/print.lsp?r=2702&1=en> (accessed July 28, 2004); Gibraltar Financial Services Commission, *About Us – Commission* <www.fsc.gi/fsc/commission.htm> (accessed Aug. 18, 2004); Financial Services Commission of Jamaica, *Brief History* <www.fscjamaica.org/public_info_files/page0013.htm> (accessed Aug. 18, 2004); Gulmira Kapenova, Supervision of the Securities Market in Kazakhstan (April, 2004) <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 12 (Feb. 2004); *Taiwan Combining Financial Regulators to Bring in Investors*, TAIWAN NEWS <http://www.etaiwannews.com/Business/2004/07/01/1088646504.htm> (1 July 2004); and Franco van Zyl, Financial Regulation Lagging, Sunday Business Times <www.btimes.co.za/98/0329/btmoney/money17.htm> (accessed Nov. 12, 2002).

[420] Martínez and Rose, *supra.* note 370 at 4 ; Honey Madrilejos-Reyes, *Senate Proposes Single Financial Regulation*, MANILA TIMES <www.manilatimes.net/national/2003/jun/17/business/20030617bus7.html> (June 17, 2003).

[421] Kaario Jännäri, *Means, Strategies and Internationalization of Financial Supervision*, FINNISH FINANCIAL SUPERVISION AUTHORITY BULLETIN 1, 7 (1998) (may be accessed at <www.rahoitustarkastus.fi/english/publications/data/speeches_and_articles/1jannari.pdf >). 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. *Id.*

[422] 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.

[423] 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. Martinez and Rose, *supra*. note 370 at 13. Latvia and Singapore have not subjected leasing companies to regulation by their respective integrated financial service regulators. *Id.*

[424] GAO FINANCIAL REGULATION REPORT, *supra.* note 8 at 131.

had 2,300 employees while the total number of employees in the existing state and federal regulators in the United States range from about 30,000 to 40,000.[425]

First, the US FSA would probably employ fewer people than currently are employed by all of the existing U.S. financial regulators, because it would eliminate previously duplicative requirements and the people who administered them. When Germany consolidated its banking, securities, and insurance regulatory agencies to create its single regulator, BaFin, it reduced the number of staff employed by the financial regulators by about 20% between 2001 and 2003.[426] Second, 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 the current system, in which employees from one regulator contend with those in other regulators for regulatory turf.

Certainly creating a large agency is going to face more political obstacles than creating a small agency. 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. It would not even make the list as one of the ten largest federal departments or agencies.[427] The US FSA, in fact, would be over 33% smaller than the average size of the existing federal cabinet departments excluding the Department of Defense, the Department of Veterans Affairs, and the Department of Homeland Security, which are disproportionately large in size when compared with the other cabinet departments.[428]

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[425] *Id.*

[426] UK FSA ANNUAL REPORT 2000/01, *supra.* note 359 at 80; UK FSA ANNUAL REPORT 2002/03, *supra.* note 334 at 205. The number of staff for the German federal banking, securities and insurance regulators in 2001 totaled 1133 and the number of staff for BaFin in 2003 totaled 901. UK FSA ANNUAL REPORT 2000/01, *supra.* note 359 at 80; UK FSA ANNUAL REPORT 2002/03, *supra.* note 334 at 205.

[427] Office of Management and Budget, Budget for Fiscal Year 2005 <www.whitehouse.gov/omb/budget/fy2005> (March 1, 2005). 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.

[428] Office of Management and Budget, Department of the Treasury <www.whitehouse.gov/omb/budget/fy2005/treasury.html> (March 1, 2005); Office of Management and Budget, Department of Commerce, <www.whitehouse.gov/omb/budget/fy2005/commerce.html> (March 1, 2005).; Office of Management and Budget, Department of State <www.whitehouse.gov/omb/budget/fy2005/state.html> (March 1, 2005); Office of Management and Budget, Department of Housing and Urban Development <www.whitehouse.gov/omb/budget/fy2005/hud.html> (March 1, 2005); Office of Management and Budget, Department of Education <www.whitehouse.gov/omb/budget/fy2005/education.html> (March 1, 2005); Office of Management and Budget, Department of Agriculture <www.whitehouse.gov/omb/budget/fy2005/agriculture.html> (March 1, 2005). Office of Management and Budget, Department of Justice

In addition, 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 the US FSA merger in terms of number of employees.[429] The Department of Homeland Security has roughly 4½ times the total number of employees currently working in all federal and state financial regulatory agencies.[430]

Certainly Congress is more likely to be motivated to create a large financial regulator, like the US FSA, if the United States experiences a major financial crisis. Prior to the attacks on the World Trade Center and the Pentagon on September 11, 2001, few in the United States would have foreseen the creation of the Department of Homeland Security. Following those attacks, there was sufficient political momentum to propel the legislation to create this department rapidly through Congress. It is possible that some future financial crisis will help build the political coalition to create a US FSA. Financial crises in the Nordic countries and in the United Kingdom were the sparks that created the political will in those nations to create single financial regulators.

C. *US FSA May Have Difficulty Prioritizing Issues*

<www.whitehouse.gov/omb/budget/fy2005/justice.html> (March 1, 2005); Office of Management and Budget, Department of Labor <www.whitehouse.gov/omb/budget/fy2005/labor.html> (March 1, 2005); Office of Management and Budget, Department of Transportation <www.whitehouse.gov/omb/budget/fy2005/transportation.html> (March 1, 2005); Office of Management and Budget, Department of Energy <www.whitehouse.gov/omb/budget/fy2005/energy.html> (March 1, 2005); Office of Management and Budget, Department of Health and Human Resources <www.whitehouse.gov/omb/budget/fy2005/health.html> (March 1, 2005); Office of Management and Budget, Department of Interior <www.whitehouse.gov/omb/budget/fy2005/interior.html> (March 1, 2005); Office of Management and Budget, Department of Defense <www.whitehouse.gov/omb/budget/fy2005/defense.html> (March 1, 2005); Office of Management and Budget, Department of Homeland Security <www.whitehouse.gov/omb/budget/fy2005/homeland.html> (March 1, 2005); Office of Management and Budget, Department of Veterans Affairs <www.whitehouse.gov/omb/budget/fy2005/veteransaffairs.html> (March 1, 2005). 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 Management and Budget, Department of Defense <www.whitehouse.gov/omb/budget/fy2005/defense.html> (March 1, 2005); Office of Management and Budget, Department of Homeland Security <www.whitehouse.gov/omb/budget/fy2005/homeland.html> (March 1, 2005); Office of Management and Budget, Department of Veterans Affairs <www.whitehouse.gov/omb/budget/fy2005/veteransaffairs.html> (March 1, 2005).

[429] Office of Management and Budget, Department of Homeland Security <www.whitehouse.gov/omb/budget/fy2005/homeland.html> (March 1, 2005);

[430] *Id.*

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 this problem if it provided a clear set of goals in the act that would create the US FSA.

D. *US FSA May be Unresponsive to Small Firms*

This problem could be raised against any consolidation of regulators. Merely increasing the size of the 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 concern, a separate small business panel could be created to ensure that the US FSA has to address 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 by the way the US FSA is organized. Under my proposal as described in Part IV above, 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 build and retain the specialized knowledge pertaining to certain sectors and businesses.

F. *US FSA May Lack Accountability*

How the regulator is structured will determine how accountable it is. I have proposed several features that would enable Congress, practitioners and consumers to hold the US FSA accountable for actions in Part IV. These features include the practitioners' and consumers' panels and the annual and periodic reports to Congress, as well as the possibility of creating a special office to investigate complaints against the US FSA. All of these features would aid in hold 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 result in insufficient funds to complete the integration of agencies;
- One approach to supervision dominating the others may occur, particularly when one agency, usually the banking regulator, has more staff, resources and facilities prior to the merger of the agencies.
- Market confusion may arise 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.[431]

I recognize that the United States would face legal constraints that would require making major amendments to its existing legislation in order to create the US FSA. The burden of doing so, however, could be mitigated if Congress was willing to pass a single bill containing all of the necessary changes. This is how the UK created the UK FSA, and it avoided some of the problems that other countries faced because their legislatures chose to pass multiple acts rather than one.

In terms of the loss of personnel, the United States probably would face this problem. Nine countries out of the 14 countries surveyed by Martinez and Rose reported losing experienced personnel following the integration of their agencies and eight countries reported that the staff of the merged entities during and after the integration process were demoralized.[432] The reasons for these problems stem from the uncertainty engendered by the merger process, the possibilities of layoffs, and the delays in establishing the structure of the unified entity, appointing the heads of departments, and establishing the conditions of employment.[433] On average, the 14 nations surveyed reported that it took between 0.7 of a year to 0.9 of a year to appoint the new heads of the departments in the integrated entity, integrate budgetary processes, and reallocate personnel.[434] Once the transition process was complete, however, some nations like the United

[431] Martinez and Rose, *supra*. note 370 at 27-31.
[432] *Id.* at 27-28.
[433] *Id*. at 28.
[434] *Id*. at 30.

Kingdom reported that the unified agency was considered a more desirable employer than any of the former agencies, which made recruitment easier.[435]

In terms of integrating information technology, again the United States most likely would experience this problem. Eight countries out of the 14 surveyed reported that they experienced delays in integrating the information technology systems and the infrastructure of the former agencies.[436] The 14 nations surveyed reported that it took them 1.1 years to integrate the information systems of the merged agencies.[437] In addition, the Department of Homeland Security had to deal with information technology problems when it merged the 20 prior agencies together to create the department. Since all of the state and federal regulators do not use the same computer systems, information technology problems are going to arise. Nevertheless, these problems are transitory and are outweighed by the benefits that will result from creating the US FSA.

Only two nations reported other managerial problems, such as budgetary problems or lack of mission.[438] Nevertheless, on average, it took the 14 surveyed nations two years to establish the definitive structure of the integrated agency.[439] Both of these problems can be address by making adequate budgetary appropriations and by incorporating a mission statement into the act creating the US FSA. In addition, by creating a new agency and not merging the other agencies into a dominant agency like the Federal Reserve, the United States would avoid the problem of one regulatory approach dominating the others. The problem of market confusion also could 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 that I proposed is adopted, the US FSA would not suffer from the lack of regulatory and supervisory independence that arose in Japan. 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 that management of the new US FSA will be unable to focus on important supervisory tasks while trying to integrated the different agencies during a financial crisis, could be avoided by Congress if it would pass legislation now to create the US FSA before a major financial crisis occurs.[440] Unfortunately, history shows that Congress frequently waits for a financial crisis to erupt before it acts.

[435] *Id.* at 28.
[436] Id. at 27-28.
[437] Id. at 30.
[438] Id. at 27-28.
[439] Id. at 30.
[440] Id. at 31.

None of the problems raised above pose insurmountable obstacles to creating a single financial authority. Careful planning could avoid most of the problems. The United States can benefit from the experiences of others when it creates it US FSA because it can draw on their experiences to plan ways to avoid the problems that they faced.

VII. Conclusion

The United States would greatly benefit from consolidating its existing financial regulatory agencies into a single agency. The optimal number of agencies to be involved in the regulation of the financial services industry in the United States is certainly a number far smaller than the over 115 agencies that currently exist.

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, eliminate regulatory gaps, harmonize regulations for financial products and firms that are competitors 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 amount spent by the current regulatory regime and at a lower cost than the alternatives proposed by the GAO. The time has come for the United States upgrade its obsolete financial regulatory system to a single financial regulator for the twenty-first century and beyond.