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BACK TO BASICS: WHY FINANCIAL REGULATORY OVERHAUL IS OVERRATED

RENEE M. JONES*

I. INTRODUCTION

Our current economic and financial crisis has predictably led to calls for an overhaul of our financial regulatory structure. The dominant reform proposals are premised on the notion that our system of financial regulation has failed to keep up with the realities and complexities of modern financial markets. Reform proponents thus urge sweeping changes that would eliminate many of our principal regulatory institutions and replace them with a few bigger and better agencies. There are several variations on this theme, but the dominant proposals envision consolidating multiple agencies that currently oversee banks, insurers, and brokerage firms into one or two national regulatory bodies.

In this essay, I suggest that regulatory overhaul is the wrong prescription for our times. We should instead pursue a "Back to Basics" approach to regulatory reform. A Back to Basics strategy is founded on the notion that the regulatory system erected as part of the New Deal, while imperfect, worked for more than seventy years to forestall the kind of catastrophic collapse we are currently experiencing. On this analysis, the current crisis cannot be properly attributed to a failure to modernize financial regulation. It is instead more appropriate to view the current collapse as the end result of a systematic effort to dismantle the regulatory structure created during the New Deal.

Over the past thirty years Congress and the courts have chipped away at the foundation of the financial regulatory apparatus that was constructed in the aftermath of the 1929 market crash.[1] Under the guise of clever and cheerful labels such as "Improvement," "Modernization," and "Reform," the New Deal structure has been effectively dismantled. While most of the New Deal legislation and institutions remain in place, their

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[1] *See generally* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET (Northeastern University Press 1995).

effectiveness has been undermined by a host of legal developments, leaving an illusion of financial regulation that masked the reality that the regime had been so weakened that it was no longer capable of managing mounting conflicts of interests or controlling systemic risk. By itself each chip at the mortar of our regulatory system seemed unremarkable. Collectively, their impact has been far worse than even the greatest skeptics of deregulation might have imagined.

Perhaps the most significant deregulatory reform of the era was the erosion and eventual repeal of the Glass-Steagall Act,[2] the 1930s legislation that mandated separation between investment banking and commercial banking. Through persistent lobbying efforts by commercial banks, the Glass-Steagall wall was weakened and finally repealed when Congress passed the Gramm-Leach-Bliley Act of 1999.[3] To restore economic stability and financial soundness we should reinstate the separation between commercial banking and more risky enterprises and return to a financial industry populated by more, smaller banks.[4]

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[2] Glass-Steagall is more formally known as the Banking Act of 1933, Pub. L. No. 73-66, ch. 89, 48 Stat. 162 (1933) (codified as amended in scattered sections of 12 U.S.C.). Sections 16 and 20 of Glass-Steagall prohibited banks from underwriting or dealing in corporate securities, and from affiliating with firms engaged in such activities. Glass-Steagall Sections 16 and 20, codified at 12 U.S.C. § 24 (1994 & Supp. II 1997); 12 U.S.C. § 377 (1994). Section 21 prohibited securities firms from offering banking services. *See generally* RICHARD SCOTT CARNELL ET AL., THE LAW OF BANKING AND FINANCIAL INSTITUTIONS 16-29 (Aspen Publishers 4th ed. 2009); THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 12-13 (6th ed. 2009).

[3] Gramm-Leach-Bliley Financial Modernization Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified in scattered sections of 12, 15, 16 & 18 U.S.C.A.).

[4] A number of commentators have taken note of the problems that ensued after Glass-Steagall's repeal, yet so far few legislative proposals have emerged to reinstate the divide and the prospects for these initiatives are dim. As of this writing two bills have been introduced in the Senate to restore some of the restrictions formerly imposed by Glass-Steagall. Senator Bernard Sanders has sponsored a bill that would require the Treasury Secretary to break up any financial institution deemed too big to fail. *Big Bank "Break-Up" Idea Gains Ground in Congress*, REUTERS.COM, Nov. 6 2009, http://www.reuters.com/article/idUSN0618960720091106. Senators John McCain and Maria Cantwell have also proposed legislation to restore many of Glass-Steagall's restrictions. Michael Hirsh, *An Odd Post-Crash Couple, Spurning Obama, McCain and Cantwell Propose Resurrecting Glass-Steagall to Break Up Wall Street*, NEWSWEEK.COM, Dec. 15 2009, http://www.newsweek.com/id/226938/. For commentators who have lamented the demise of Glass-Steagall and the rise of big banks see Joseph E. Stiglitz, *Capitalist Fools*, VANITY FAIR, Jan. 2009, at 50 ("The most important consequence of the repeal of Glass-Steagall was indirect – it lay in the way repeal changed an entire culture. Commercial banks are not supposed to be high-risk ventures; they are supposed to manage other people's money very conservatively."); s*ee generally*

This essay takes issue with the dominant diagnosis that our economic problems are due to outmoded regulations that could not keep up with the realities of modern markets. It posits, instead, that the financial crisis was a foreseeable result of sustained efforts to erode the regulatory protections that emerged during the New Deal. This slow and steady erosion of regulatory controls allowed conflicts of interests to swell and let pockets of unregulated economic activity expand unchecked until they overwhelmed the regulated sectors of our financial markets. To restore confidence in our financial institutions regulatory reformers should look backward before looking forward. We need to understand better how the system failed before we can determine how best to fix it.

A Back to Basics strategy does not require the implementation of new rules or the creation of new agencies. Instead the approach contemplates an increase in enforcement efforts and the strengthening of existing agencies to equip them to better perform the duties that Congress assigned to them. The strategy is preferable to proposals to overhaul the regulatory system because it addresses weaknesses in the regulatory structure with tools that have already been proven effective. A Back to Basics strategy does not preclude further regulatory reforms that would streamline and consolidate regulatory agencies. However, in a time of crisis, a reform strategy that is clear and easy to implement offers many advantages over efforts to create a new regulatory system out of whole cloth.

Although getting Back to Basics would require a number of adjustments to current policies, this essay will focus on a reform idea that has been under-explored in policy discussions: restoring Glass-Steagall's traditional division between commercial banking and investment banking. This reform would address many of the concerns voiced by advocates of regulatory consolidation and would also create firebreaks that could dampen the impact of futures scandal or economic downturns that occur in one sector of the financial industry or the other.

Reintroducing the division between investment banks and commercial banks would allow bank regulators to focus on their area of expertise (deposit insurance and capital adequacy) while securities and market regulators focus on investor protection and curbing abuses in the capital markets. Consolidation by itself does not guarantee improved regulation and would likely increase risks of regulatory failure. Regulatory overlap and redundancy, while seemingly inefficient, actually provide important protections because regulatory agencies can backstop one

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BYRON DORGAN, RECKLESS!: HOW DEBT, DEREGULATION, AND DARK MONEY NEARLY BANKRUPTED AMERICA (AND HOW WE CAN FIX IT!) (Thomas Dunne Books 2009); Eliot Spitzer, *Too Big Not to Fail: We Need to Stop Using the Bailouts to Rebuild Gigantic Financial Institutions*, SLATE, Dec. 8, 2008, http://www.slate.com/id/2205995/.

another, making it less likely that misconduct and abuse will fall through cracks in the regulatory mortar.[5]

The recent bailouts of failing financial institutions have been justified by the assertion that these institutions are "too big to fail." Their "too big to fail" status means that corporate officials and shareholders need not take full responsibility for their mistakes, as the government must step in to save these failing institutions in order to forestall further economic catastrophe. A direct response to the too big to fail phenomenon and the moral hazard it creates is to prohibit the bailed-out banks from remaining too big to fail. Unfortunately, financial regulators have pursued the opposite course by encouraging mergers between investment banks and commercial banks that only serve to exacerbate the too big to fail dilemma.[6]

A wiser course would be for the government, first, to act to stabilize our banks to ensure their financial soundness. The next step should be a process for the orderly divestiture of investment banking assets by the major banks and vice versa. This reform seems to be a crucial step for counteracting both the too big to fail and too big to regulate phenomena that spurred the financial crisis and the unavoidable subsequent government bailout.[7]

II. THE DOMINANT MODELS FOR FINANCIAL REFORM

A common diagnosis for our current ills is that financial regulators were too fragmented, inadequately informed, and lacked sufficient authority to effectively oversee the activities of large conglomerate banks. The rapid growth in unregulated market sectors such as hedge funds and derivatives trading also deprived regulators of the information necessary to monitor and

[5] *See* Renee M. Jones, *Dynamic Federalism: Competition, Cooperation and Securities Enforcement*, 11 CONN. INS. L.J. 107, 121-26 (2004-2005).

[6] Federal regulators cajoled J.P. Morgan Chase to take over the failing Bear Stearns investment bank last spring. *See* David Cho & Neil Irwin, *Crisis of Confidence in the Market: Federal Reserve's Rescue of Bear Stearns Exposes Cracks in Financial System*, WASH. POST, Mar. 18, 2008, at A1; Robin Sidel et al., *J.P. Morgan Buys Bear in Fire Sale, as Fed Widens Credit to Avert Crisis*, WALL ST. J., Mar. 17, 2008, at A1; Andrew Ross Sorkin, *In Sweeping Move, Fed Backs Buyout and Wall St. Loans*, N.Y. TIMES, Mar. 17, 2008, at A1. Under similar pressure, the troubled brokerage giant Merrill Lynch merged with Bank of America in the fall of 2008. *See* Louise Story, *Stunning Fall for Main Street's Brokerage Firm*, N.Y. TIMES, Sept. 15, 2008, at A1; Carrick Mollenkamp et al., *Crisis on Wall Street as Lehman Totters, Merrill is Sold, AIG Seeks to Raise Cash –Fed Will Expand its Lending Arsenal in a Bid to Calm Markets*, WALL ST. J., Sept. 15, 2008, at A1.

[7] *See* Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 305 (2002) (arguing that the largest universal banks have become too big to monitor effectively).

control systemic risk. Some reform advocates reason that financial regulators need broader authority over financial institutions that pose systemic risk to the financial markets in order to prevent a recurrence of the recent market collapse.

From these observations flow prescriptions for combining our fragmented bank, insurance, and securities markets regulators into mega-institutions that can gather and digest information on all these financial products and activities. Although this prescription has a certain logical appeal, it overlooks other deeper causes of our problems. Because it fails to take into account these other crucial concerns, regulatory consolidation is unlikely to achieve the positive results its proponents promise.

The dominant proposals for financial regulatory reform cluster around two competing models for financial regulatory consolidation – the so-called "Twin Peaks" model and calls for a universal regulator. Under Twin Peaks, financial regulation would be divided between two principal objectives: Prudential Regulation and Conduct Regulation/Consumer Protection – each under the aegis of a separate regulatory agency. By contrast, a universal regulator would exercise nearly exclusive authority over all financial institutions throughout the country.[8]

These consolidation proposals are premised on the need to correct for weaknesses in our current regulatory regime in a post-Glass-Steagall environment.[9] After the barriers that historically separated the financial institutions along functional lines were dismantled, regulators faced a number of challenges in seeking to oversee the disparate business units that comprised the universal banks.[10]

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[8] *See, e.g.,* Howell E. Jackson, *A Pragmatic Approach to the Phased Consolidation of Financial Regulation in the United States* (Harvard Law Sch. Pub. Law & Legal Theory Working Paper Series, Paper No. 09-19, 2008), *available at* http://ssrn.com/abstract=1300431; Elizabeth F. Brown*, E Pluribus Unum – Out of Many, One: Why the United States Needs a Single Financial Services Agency*, 14 U. MIAMI BUS. L. REV. 1 (2005).

[9] Jackson, *supra* note 8, at 3 ("[O]ur financial regulatory structure is in profound need of reorganization.").

[10] U.S. Dep't of the Treasury, The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure (Mar. 2008) [*hereinafter* the Blueprint] (on file with the Ohio State Entrepreneurial Business Law Journal) (the current "approach to regulation exhibits several inadequacies, the most significant being the fact that no single regulator possesses all of the information and authority necessary to monitor systemic risk . . . ,").

A. *The Twin Peaks Model*

One of the more fashionable proposals for regulatory consolidation is the Twin Peaks model for financial oversight.[11] The Twin Peaks model has been adopted in Australia and the Netherlands. It provides the structural foundation for the Treasury Department's Blueprint and the G-30 proposals discussed below.

Under Twin Peaks, two principal regulatory agencies would oversee the financial markets. A Prudential Regulator would focus on ensuring the safety and soundness of major financial institutions, a function now performed by the Federal Reserve and other bank regulators. The second peak in Twin Peaks is a Business Conduct Regulator that would oversee business conduct, consumer protection, and corporate disclosure. The objective of this model is to create regulatory agencies with broad-enough authority to oversee all categories of financial institutions. Concomitant with such consolidation would be a move toward greater uniformity in oversight to be provided by increased federal regulatory authority over those financial institutions that opt in (via a federal charter) at the expense of state-based oversight.

B. *The Universal Regulator*

An alternative consolidation model is the proposal to create a single universal regulator with authority over all financial institutions throughout the country. Calls for a universal regulator are prompted by the United Kingdom's ("U.K.") adoption of this framework. In 1997, the U.K. created the Financial Services Authority ("FSA") to oversee its financial markets. The FSA has authority over banks, investment banks, financial advisers, insurers, and broker-dealers. Some commentators laud the U.K. model and urge United States policy makers to create a similar structure.[12]

The rationale for a universal regulator echoes the justification offered for Twin Peaks – because financial institutions are no longer separated along functional lines, the functional regulatory structure is obsolete.[13] Advocates also express concerns about complexity, redundancy, competence, and regulatory arbitrage to support the notion that

[11] *See, e.g.*, Michael Taylor, Twin Peaks: A Regulatory Structure for the New Century (Centre for the Study of Financial Innovation 1995); John C. Coffee, Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 7097 (2009).
[12] Jackson, *supra* note 8, at 3-4 (praising the U.K.'s single regulator model); Brown, *supra* note 8 at 7
[13] Brown, *supra* note 8, at 4-5.

bigger would be better when it comes to overseeing the financial markets.[14] They note that regulatory fragmentation, lack of expertise in agencies, low prestige for regulatory jobs, and problems of both regulatory redundancy and regulatory gaps all plague our balkanized system for overseeing financial firms.[15] In contrast to the multiple agencies that now exist, a universal regulator would be well equipped to sort out the turf battles that plague the regulatory system and to act quickly to fill regulatory gaps when necessary.[16] Thus, despite the recent high-profile failures of some of Britain's major banks,[17] these commentators recommend U.K's FSA as a model for US reform.

C. *Specific Reform Proposals*

1. *The Treasury "Blueprint"*

The starting point for most discussions of financial regulatory reform is the Treasury Department's Blueprint published in the spring of 2008 under Bush Treasury Secretary Henry Paulson.[18] The Blueprint combines recommendations for regulatory consolidation with proposals to eliminate or dilute key aspects of the regulatory structure. Most significantly the Blueprint envisions significantly weakening the securities enforcement regime (both public and private). It calls for shifting the Securities and Exchange Commission's ("SEC") enforcement functions to self-regulatory organizations (SRO's) and eliminating states' powers to enforce their securities laws.[19]

The Blueprint asserts that jurisdictional disputes among the myriad financial regulators hinder the introduction of new products, slow innovation, and force entities to pursue their activities in "more adaptive

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[14] Jackson, *supra* note 8, at 16-23 (consolidated oversight has numerous advantages); Brown, *supra* note 8, at 74-81.

[15] Jackson, *supra* note 8, at 15-17.

[16] *Id*. at 18-20

[17] *See* Julia Werdigier, *For Lack of Other Investors, Royal Bank of Scotland Sells Control to Britain*, N.Y. TIMES, Nov. 29, 2008, at B3; Emma Charlton & Laurence Norman, *U.K. Government Plans Northern Rock Revival*, WALL ST. J., Feb. 23, 2009, at C3; Alistair MacDonald, *U.K. Watchdog Adds More Bark, Bite: FSA's Lax Approach Faulted in Bank Meltdown; Avoiding Next Northern Rock*, WALL ST. J., Jan. 5, 2009, at C2.

[18] Blueprint, *supra* note 10.

[19] *Id.* at 20, 178-80; *see also* Coffee & Sale, *supra* note 11, at 767-73; Secretary of the Commonwealth of Massachusetts, Securities Division, *States' Demonstrated Record of Effectiveness In Their Investor Protection Efforts Underscores the Need to Avoid Further Preemption of State Enforcement Authority* 10-11 (Dec. 2008) (discussing the Blueprint's proposal and arguing for retaining state enforcement authority).

foreign markets."[20] It therefore recommends an "objectives" based regulatory approach that is a variation on Twin Peaks. The Blueprint identifies three key regulatory objectives: (1) market stability; (2) safety and soundness; and (3) business conduct, and recommends the creation of a distinct regulatory agency charged with each objective.[21] The "Prudential Financial Regulatory Agency ("PFRA") would monitor safety and soundness,[22] the Conduct of Business Regulatory Agency ("CBRA") would handle licensing and consumer protection, [23] and the Fed would play the role of market stability regulator, and would focus sharply on controlling systemic risk.[24]

The Blueprint also recommends merging the Commodity Futures Trading Commission ("CFTC") and the SEC and suggests that such consolidation should be preceded by the SEC's adoption of the more porous principles-based model of regulation that the CFTC employs.[25] The Blueprint describes the CFTC's principles-based approach as "more conducive to the modern marketplace."[26] Such a move envisions the dilution of the SEC's regulatory power vis-à-vis recommendations for regulatory forbearance with respect to new products and "global investment companies," and the adoption of a self-certification regime for new SRO rulemaking, and a self-regulatory regime for financial advisers.

2. *The G30 Framework*

In January 2009, the Group of Thirty ("G30") released its Report on Financial Reform ("G30 Report"). [27] The G30 Report seems to have replaced the Blueprint as the starting point for President Obama's reform proposals. Like the Blueprint, the G30 Report focuses on the need for effective prudential regulation and recommends the designation of a

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[20] Blueprint, *supra* note 10, at 4.
[21] Blueprint, *supra* note 10, at 13-14.
[22] *Id*. at 14. The PFRA would assume the role of the Office of the Comptroller of the Currency and the Office of Thrift Supervision.
[23] *Id*. The CBRA would address the business conduct of all financial institutions and would take on a consumer/investor protection role.
[24] *Id.* at 15.
[25] Id. at 11-13.
[26] *Id.* at 12.
[27] Group of 30, *Financial Reform: A Framework for Financial Stability*, January 2009. The Group of 30 ("G30") Working Group on Financial Reform was chaired by Paul Volcker, one of President Obama's economic advisers. The G30 had already issued a report on the structure of financial regulation that seemed to endorse the Twin Peaks model. Press Release, Group of Thirty, Reforms of Banking Regulation Seen as Urgent – Approaches in Many Countries Fall Short in the Face of Today's Market Strains, the Pace of Financial Innovation and Globalization (October 6, 2008) (available at http://www.group30.org/100608release.pdf).

prudential regulator with power to oversee all financial institutions with the potential for creating systemic risk, regardless of the type of financial product or services they provide.[28] Unlike the Blueprint, which favors self-regulation or light regulation over robust government oversight, the G30 Report envisions an expanded federal regulatory role.

The G30 Report includes specific recommendations on policies a prudential regulator should adopt, including prohibiting banks from sponsoring hedge funds or engaging in large-scale proprietary trading, limiting deposit concentrations at banks, regulating hedge funds and private equity groups to monitor for systemic risk, and creating a structure for over-the-counter derivatives trading.[29] The G30 Report also recommends more robust standards for risk management and governance for financial firms, although its recommendations on this point are vague.[30]

3. *The Obama Plan*

In June 2009, President Barack Obama released the details of his administration's much-anticipated proposal for financial regulatory reform (the "Obama Plan").[31] The Obama Plan appears to draw heavily on the G30 Report, but it deviates from the G30 Report's recommendations in several respects. Most notably, the plan disregards calls for regulatory consolidation and would instead create *new* federal agencies and offices charged with financial regulatory matters.

The centerpiece of the Obama Plan is the proposal to vest the Fed with new powers to act as a systemic risk regulator. In this role, the Fed would assume oversight not only over banks and their holding companies, but also over any financial institution deemed to be systemically significant. Systemically significant financial institutions would be designated "Tier 1" firms, and the Fed would have the power to impose restrictions on these firms regarding of capital adequacy, risk management and compensation practices that exceed those applicable to other financial institutions.

By giving the Fed expanded powers for prudential regulation, the Obama Plan embraces Twin Peaks' call for a systemic risk monitor; yet it departs from Twin Peaks because the Fed would not have a singular objective. In addition to monitoring systemic risk, the Fed would continue to manage monetary policy, market stability and other important tasks. Furthermore, the Obama Plan leaves "business conduct" regulation under the purview of a wide-ranging alphabet soup of financial regulators.

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[28] G-30 Report, *supra* note 27, at 17.
[29] *Id*. at 28-29, 52-53.
[30] *Id* at 40-42.
[31] Department of the Treasury, *A New Foundation: Rebuilding Financial Supervision and Regulation (*June 2009*), available at* http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

The Obama Plan would eliminate only one financial agency – the Office of Thrift Supervision, and would create a new Consumer Financial Protection Agency to focus on consumer protection in credit cards, mortgages and other financial products. It would also add a new National Insurance Office to monitor the insurance industry.

The Obama Plan would also grant the Fed and the FDIC "resolution authority" over systemically significant financial firms, whether operating as a bank or otherwise. This would give the federal government power to take receivership of failing or insolvent financial institutions whether banks, bank holding companies, insurance groups or otherwise. This would allow for the orderly unwinding of failing financial institutions without the risk of destabilizing the economy as the Lehman Brothers bankruptcy did.

The impact of the Obama Plan ultimately depends on how effectively the Fed (or other regulator) exercises its authority as a systemic risk monitor. Many commentators and legislators have expressed misgivings about the Fed's prospective role.[32] They point to the Fed's failure to protect consumers from predatory lending practices which played a central role in fueling the subprime mortgage market, and its participation in the bailouts of Bear Stearns, Merrill Lynch and AIG to underscore their doubts. Equally ominous for the Obama Plan, several senior financial regulators have expressed concerns with the proposal. FDIC Chair, Sheila Bair, and TARP Overseer, Elizabeth Warren have both stated a preference for granting the Financial Oversight Council, a broader group of regulators, to authority to monitor systemic risk.[33]

D. *Problems with Consolidation Proposals*

The dominant proposals for regulatory restructuring, including the Obama Plan, suffer from a common set of weaknesses. First, these reform models tend to eschew substance and instead pin their hopes on the belief that reshuffling regulatory authority by itself will improve the

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[32] *See* Edmund L. Andrews, *Two Authorities on Fed Advise Congress Against Expanding its Power*, N.Y. TIMES, July 10, 2009, at B3; Sudeep Reddy, *The Financial Regulatory Plan: Not Everyone is Cheering Fed's New Role*, WALL ST. J., June 18, 2009, at A9 (quoting Senator Dodd and Representative Frank as lacking confidence in the Fed).

[33] David Cho, Binyamin Appelbaum & Zachary A. Goldfarb, *Goals Shift for Reform of Financial Regulation; Anticipating Resistance; Obama Changes Track*, WASH. POST, June 10, 2009, at A01 (quoting FDIC Chair Sheila Bair). The financial reform bill approved by the House in December 2009 delegates authority over systemically significant firms to a financial services oversight council comprised of the heads of federal financial regulatory agencies. *See* Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (1st Sess. 2009).

effectiveness of regulation. It is more important, however, for policymakers to focus on the rules regulators would adopt and how they would enforce them, than what to call an agency or what sectors of the financial industry it would oversee.

Second, most regulatory overhaul plans fail to build on the strengths of our existing regulatory system, despite its proven track record prior to the deregulatory era. For most of its existence, the SEC has been one of the most effective federal agencies, yet many reform proposals would sweep away the SEC to make way for its newer, bigger, and better counterparts. It is to President Obama's credit that he has so far resisted calls to consolidate financial regulation and has instead adopted a more incremental approach to regulatory reform.

Third, a significant degree of risk accompanies efforts to create new agencies and rules out of whole cloth.[34] There is logic inherent in the impact of path dependency on regulation. By building on prior experience we can preserve institutional knowledge and expertise that can protect regulators from having to relearn hard lessons from the past. An incremental approach to reform protects the expectations of regulated parties and as well as those whose interests the regulation is meant to serve.

The unprecedented size and power of the newly proposed agencies also cautions restraint. Consolidation could result in the creation of unwieldy agencies that are difficult to administer and control. Risks of regulatory capture and regulatory missteps intensify with a consolidated regulator. The elimination of alternative agencies with jurisdiction over financial institutions means the absence of a backstop when the principal regulator falls asleep at the switch.[35]

Finally, coordination of the type envisioned by consolidation proposals may be more elusive than its proponents predict. Our most recent experience with large-scale consolidation has not been an unqualified success. The Department of Homeland Security has still not been able to bring the agencies it oversees into better cooperation and coordination.[36]

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[34] *See* Joseph J. Norton, *Global Financial Sector Reform: The Single Financial Regulator Model Based on the United Kingdom FSA Experience – A Critical Reevaluation*, 39 INT'L LAW. 15, 19 (2005) ("[E]ach country situation is *sui generis*, with the best, informed decision dependent on and taking regard of local historical, social, economic, financial market, regulatory and political factors and conditions.").

[35] *See* Jones, *supra* note 5, at 125-26 (describing state securities regulators' intervention when the SEC failed to heed whistleblowers' complaints).

[36] *See* P.J. Crowley, *Homeland Security and the Upcoming Transition: What the Administration Should Do to Make Us Safe at Home*, 2 HARV. L. & POL'Y REV. 289, 300-01 (2008) (listing among the Department's problems its lack of a clear set of priorities, weak management systems, no unifying culture or effective leadership, and poor employee morale); Stephen R. Heifetz, Op-Ed, *The Risk of Too Much Oversight*, N.Y. TIMES, July 21, 2008, at A19 (describing the tangled

The federal behemoth still operates out of many different buildings across the country and the turf-battles and information sharing problems that spurred its creation persist.

IV. BACK TO BASICS: RESTRUCTURING THE FINANCIAL INDUSTRY INSTEAD OF FINANCIAL REGULATION

Proponents of regulatory consolidation premise their analysis by observing that the current regulatory structure is outdated in the post Glass-Steagall era.[37] They emphasize the need to update regulation to reflect the realities of modern financial markets. Unfortunately their proposals to restructure financial regulation do not grapple fully with all of the regulatory challenges created by Glass-Steagall's repeal.

A. *Unintended Consequences of Repealing Glass-Steagall*

When Gramm-Leach-Bliley became law, several commentators warned that the erosion of the traditional wall that divided commercial banking and investment banking could lead to a major financial crisis.[38] Chief among the problems the new law engendered was an unhealthy concentration of assets within a very few financial institutions.[39] A merger wave, already

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mess of homeland security laws that threaten the department's effectiveness); Griff Witte & Spencer S. Hsu, *Homeland Security Contracts Abused: Report Finds Extensive Waste*, WASH. POST, July 27, 2006, at A1 (pointing to the insufficient resources needed to take on its post-consolidation responsibilities).

[37] *See* Blueprint, *supra* note 10, at 3-4; Committee on Capital Markets Regulation, Interim Rep. 59-70 (2006), *available at* http://www.capmktsreg.org/research.html.

[38] *See, e.g.*, J. Robert Brown, *The "Great Fall:" The Consequences of Repealing the Glass-Steagall Act*, 2 STAN. J. L. BUS. & FIN. 129, 130 (1995) (predicting "the repeal of Glass-Steagall will provide, at best, marginal benefits while causing considerable damage to the securities markets"); Samuel Hayes III, *The Impact of Recombining Commercial and Investment Banking*, 70 BROOK. L. REV. 39, 44 (2004) (describing how banks sacrificed their core lending business in pursuit of expanded investment banking opportunities); Matthew J. Restrepo, *The Convergence of Commercial and Investment Banking Under the Gramm-Leach-Bliley Act: Revisiting Old Risks and Facing New Problems*, 11 LAW. & BUS. REV. AM. 269, 273 (2005) (warning that the kinds of risky activities allowed by Gramm-Leach-Bliley "could potentially jeopardize the safety and soundness of a bank and the stability of the banking system as a whole.").

[39] Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 CONN. L. REV. 963, 975-78 (2009); *See* Kenneth D. Jones & Robert C. Oshinsky, *The Effect of Industry Consolidation and Deposit Insurance Reform on the Resiliency of the U.S. Bank Insurance Fund*, 5 J. FIN. STABILITY 57, 58 (2009).

underway, accelerated as the vestiges of regulatory separation collapsed.[40] As Professor Wilmarth reports, more than "5,400 mergers took place in the U.S. banking industry from 1990 to 2005, involving more than $5.0 trillion in assets."[41] Thus, the share of banking assets held by the ten largest banks more than doubled during that period, from twenty to fifty-five percent.[42]

Furthermore by 2006, the four largest securities firms (Merrill, Morgan, Goldman, and Lehman) had essentially become universal banks, offering an array of securities, banking, and lending services.[43] As legal barriers fell, most practical distinctions between commercial banks and investment banks faded as both types of institutions began to pursue similar business models.[44] Banking firms acquired securities subsidiaries, and securities firms attained deposit taking power to compete with banks in attracting FDIC-insured deposits that served as an attractive source of capital.[45]

Glass-Steagall's repeal also allowed large banks to gamble with depositors' funds, engaging in increasingly irresponsible risks in an effort to match the higher returns of their "investment banking" peers. Their too big to fail status conferred an implicit government insurance guarantee, which allowed them to operate on lower capital and take on greater risks than smaller banks. Capital markets were willing to tolerate their higher risk profiles because markets assumed (correctly) that in a worst-case scenario the government would not allow these big banks to fail.[46] Thus, large banks expanded further and further into high-risk activities and investments, including high-yield debt, syndicated lending, securitizations, sub-prime loans and over-the-counter derivatives.[47] These high risk gambits exemplify the moral hazard that accompanies too big to fail status.

In short, Glass-Steagall's repeal and other deregulatory measures led to the reality that the financial health of the economy was dependent upon a very few institutions that were not only too big to fail, but also too big to regulate.[48] To restore stability to the financial markets, financial reform must address this daunting problem.

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[40] Wilmarth, *supra* note 7, at 251-54.
[41] Wilmarth, *supra* note 37, at 975.
[42] *Id.* at 975-76.
[43] *Id.* at 978.
[44] CARNELL, ET AL., *supra* note 2, at 28-29 ("No longer do clear cut separations exist between banking products and securities, between securities and insurance, or between banking and insurance.").
[45] Wilmarth, *supra* note 7, at 424-25 (describing securities firms' control over thrifts and other deposit taking institutions that were used to establish "sweep" accounts for brokerage customers).
[46] *Id.* at 300-02.
[47] *Id*. at 372.
[48] *Id*. at 250-52, 305-307.

B. *Benefits of Restoring the Glass-Steagall Wall*

With hindsight, we can see that the Glass-Steagall wall served two primary functions in preserving economic stability. First, the wall simplified the tasks of financial regulators. The Federal Reserve and other bank regulators were in charge of banks and other deposit collecting institutions. State insurance regulators oversaw insurance firms, and the SEC and stock exchanges took charge of investor protection by regulating capital markets, broker-dealers, mutual funds and corporate financial disclosure practices.

A less apparent advantage of this arrangement was that it limited the adverse impact of regulatory failure by any single agency. Problems stemming from regulatory failures could be contained effectively within one sector of the economy. In addition, the Glass-Steagall wall provided a natural firebreak that limited the economic dangers of systemic risk. The capital markets sector and the banking sector could backstop one another during periodic crises that occurred in either sector.[49] Banks could provide credit to corporations when the capital markets froze, and capital markets could finance corporations when the banking sector contracted.[50] This meant that the economic contagion from a bank collapse or credit freeze could be more readily contained.

Equally troubling is the reality that the anticipated benefits of industry consolidation promised by the repeal of Glass-Steagall failed to materialize.[51] Contrary to promises of improved profitability from synergies and economies of scale, bigger banks did not become more profitable.[52] In fact, many expected advantages turned out to be liabilities as universal banks were unable to meet consumers' expectations due to their size and the impersonal nature of their enterprises.[53] The efforts of large financial institutions to expand their product lines through "one-stop shopping" failed because consumers preferred to purchase financial services from specialized firms rather than financial conglomerates.[54] Financial institutions are more likely to recover quickly and sustainably if

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[49] Wilmarth, *supra* note 7, at 451-52.

[50] *Id.* at 235-236 (describing banks' role as a provider of backup liquidity when capital markets for commercial paper froze).

[51] *Id.* at 223. Professor Wilmarth states that proponents of "universal banking" promised that the new financial conglomerates would offer increased profitability due to economies of scale, increased safety and soundness through diversification, and lower costs and more convenience for consumers due to the benefits of "one-stop shopping."

[52] *Id*. at 272-77.

[53] *Id*.

[54] *Id.* at 432-33, 439.

they focus on their strengths and strive to provide the services that consumers and corporations need.

If we were to restructure the financial industry to reflect anew the traditional division between capital raising and commercial lending functions we would reduce the need to overhaul the entire regulatory system.[55] The task of regulatory reform would be simplified as we would only need to ensure that the bank regulatory system works well for banks, securities regulations adequately discipline securities dealers, and issuers and insurance regulators are equipped to oversee the activities of insurance firms.

C. *Restructuring the Financial Industry*

Although breaking up the large financial firms sounds like a radical step, ample historical precedent exists for such government mandated action. In the 1930s, banks successfully spun off their investment banking business, and financial institutions on both sides of the dividing line thrived for many decades. In fact, the investment banks did so well they became the envy of their commercial banking peers, which led to the lobbying efforts that brought Glass-Steagall down.

Other historical precedents for industry restructuring include the break-up of utility holding companies mandated by the Public Utility Act of 1935,[56] and AT&T's restructuring as part of an antitrust settlement. A wave of market-driven restructurings also occurred during the leveraged buyout boom of the 1980s. More recently, the large U.S. accounting firms spun-off their consulting practices after Sarbanes-Oxley prohibited auditors from providing business consulting services to their audit clients. Although these industry reforms were disruptive in many ways, they also brought benefits by increasing consumer choices, encouraging innovation, simplifying regulators' tasks, and eliminating harmful conflicts of interest. Eventually investors, consumers, and the market adjusted to the new reality, and life went on.

Although some may argue that breaking up big banks will impose unreasonable costs on investors and could harm U.S. competitiveness, these concerns are belied by history. The atomization of power commanded by the Glass-Steagall structure is one of the factors that helped the U.S. develop the deep and liquid securities markets that have become the envy of the world.[57] Furthermore, large financial institutions became weaker, not

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[55] Norton, *supra* note 33, at 18-19.

[56] Public Utility Act of 1935, Pub. L. No. 74-333, 49 Stat. 803 (1935) (codified as amended at 15 U.S.C. §§ 79-79z-6 et seq. (repealed 2005).

[57] *See* MARK J. ROE, STRONG MANAGERS WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (Princeton University Press 1994) 256-57; Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641,

stronger, in the wake of Gramm-Leach-Bliley.[58] It is difficult to imagine how restoring the status quo ante could do more harm to the economy than the cascade of disasters that Gramm-Leach-Bliley has wrought.

V. CONCLUSION

Although the bank regulatory system and the securities regime must be dramatically improved, calls for massive regulatory consolidation are misplaced. The most often cited rationale for such an overhaul points directly to the need for the approach suggested here. Instead of consolidating the regulators, we should de-consolidate the financial industry. A structural separation between investment banks and commercial banks can do more to protect the economy than close bureaucratic supervision of too big to fail firms could ever hope to achieve.

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645 (1996) (popular distrust of large aggregations of capital assured the development of weak financial intermediaries and stronger capital markets); Wilmarth, *supra* note 7, at 441 (competition between commercial banks and investment banks led to innovation and higher efficiencies for U.S. financial sector as compared to Europe).

[58] Wilmarth, *supra* note 7, at 411-13.