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US Financial Regulation and the Level Playing Field

Helen A. Garten
Professor of Law
Rutgers University School of Law
Newark
New Jersey

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Preface

Does regulation matter? That question is being asked more and more frequently by students of US financial markets, especially now that US policymakers, after many false starts, have signaled their willingness to overhaul US financial regulatory structure by dismantling legal barriers to financial industry diversification and consolidation. Now that banks, securities firms and insurance companies at long last may enter each others' businesses in US markets, will there be anything left for financial regulatory scholars to talk or write about? Will deregulation finally bring about the convergence of US financial law with other financial regulatory schemes, ending America's distinction of having the most heavily regulated financial markets in the world?

The answer is probably no, for several reasons. First, despite deregulation, US financial institutions will not be treated from a regulatory standpoint just like any other business enterprise. Although in late 1999 Congress finally amended national banking laws to permit combinations of banks with other financial firms, there was surprisingly little political will to complete the deregulatory process by dismantling all legal barriers between banking and commerce. This lack of interest may have reflected the fact that US financial regulation continues to impose tight restrictions on interaffiliate funds transfers from banks to their non-bank operations, removing a key incentive for commercial firms to combine with banks. In any event, for now, US financial regulation continues to resist transition to the full universal banking model.

This suggests a second reason why regulation still matters. Despite considerable deregulation, much of the US financial regulatory framework endures, and it continues to influence both the ways in which US financial markets operate and the US government's attitude toward issues of cross-border financial regulation. Financial experts in the US need not worry that deregulation will render them obsolete. Regulatory critics will still complain of overregulation. And regulatory supporters will still advance the US approach as a model for regulation of international financial markets.

Finally, in the US, financial regulatory reform tends to increase rather than decrease regulatory complexity. The Banking Act of 1933 (commonly known as Glass-Steagall), the source of much of classic US bank regulation, including the federal deposit insurance program and the separation of commercial and investment banking, contained just thirty-four sections. The Gramm-Leach-Bliley Act, that repealed key portions of Glass-Steagall in 1999, ran to over one hundred sections. The legislation permitted affiliations among bank, securities and insurance firms, but financial institutions remain closely regulated. A financial firm's choice of organizational form continues to determine permissible powers and responsible regulatory authority. To outside observers, this may sound suspiciously like the state of affairs that prevailed under the old regulatory regime. Financial firms seeking to do business in the US in the future must be concerned with many of the same legal questions that they asked in the past: Who regulates? What activities may be conducted within a bank, or an affiliate, or a subsidiary? And why, in the US, does financial modernization never really mean regulatory simplification?

This book seeks to answer the last question by offering a perspective on the forces that drive the US financial regulatory process. Understanding why the US regulates its financial markets may help to explain how US financial regulation gains and retains legitimacy. This, in turn, may offer some insight into the recent deregulatory process that, although producing changes in the specifics of financial law, has ensured that regulation will continue to matter very much in US financial markets of the future.

This book does not claim to offer a complete account of the current state of US financial regulation. Financial regulation is extraordinarily complex, deriving from multiple legal sources, both national and state, legislative and administrative. Moreover, regulation is in the process of transition, frustrating efforts to predict what the law will be years, or even months, from now. (For example, throughout 1999, prospects for enactment of long awaited financial modernization legislation appeared uncertain up until the very moment that final agreement was reached between Congress and the White House.) Therefore, any comprehensive description of where the law stands today runs the danger of sudden obsolescence as well as demanding a level of detail that is beyond the scope of this book.

Instead, this book will focus on certain fundamental norms, easily described and relatively constant, that influence the process by which financial regulation (and deregulation) are legitimized and delegitimized in the US. In so doing, it will attempt to account for the anomaly, long apparent to outside observers but often overlooked by US financial market players, that despite the US's professed commitment to promoting freer and more open financial markets, particularly abroad, its own financial markets do not always appear to be so free. The explanation may be found in the peculiar role that US financial market players assign to regulation. Regulation is legitimized to the extent that it furthers the particular requirements of competitive fairness that US financial players demand from their financial markets. The purpose of financial regulation, simply put, is to create a more level playing field, a perspective that has colored the evolution of modern financial regulation in the US and is largely responsible for the positions taken by US financial players, including policymakers, on questions of international supervision of financial markets.

This book will illustrate this point by looking at several examples of how regulation has been employed in US financial markets to promote the ideals of competitive fairness. In telling these stories, it will assume that most readers have at least a passing familiarity with the basic building blocks of US financial law, such as the separation of banking and commerce, as well as with its leading statutes, which will be referenced by common name in text and notes. (For those readers to whom US financial regulation is entirely unfamiliar, a glossary is provided giving current descriptions of statutory sources.) The aim is not to distract the reader with too many specifics of US financial law, but to tell the story of financial regulation in a way that demonstrates how regulation has shaped the growth of US financial markets and, perhaps even more important, the attitudes of US financial players toward their markets.

HELEN A. GARTEN

List of Abbreviations

FDIC	Federal Deposit Insurance Corporation
LTCM	Long-Term Capital Management
NASDAQ	National Association of Securities Dealers Automated Quotations
RFC	Reconstruction Finance Corporation
US	United States of America

Glossary of Key US Financial Statutes

This glossary is designed to provide a working acquaintance with the principal national laws that have shaped modern US financial markets. It does not even attempt to reference the many state statutes that affect the business of financial firms in the US. In the last few decades, some key statutes have been amended or repealed but, to the extent that they have influenced financial market evolution and are discussed in this book, they are noted here. Although specific citations are not provided, banking law is found in volume 12 of the United States Code and securities regulation in volume 15.

The Bank Holding Company Act of 1956 prohibited commercial firms from owning or controlling banks and limited the permissible activities of bank holding companies and their non-bank affiliates to those so 'closely related' to banking as to be a proper incident thereto. In the 1980s and 1990s, the Federal Reserve, chief regulator of bank holding companies, construed this language to allow banks some flexibility to diversify their financial activities through the use of non-bank affiliates, including the securities affiliates that revolutionized US financial markets. By the late 1990s, most major banking organizations in the US had adopted the holding company form of organization. In 1999, Congress amended the Bank Holding Company Act to permit the formation of financial holding companies composed of banks, securities firms, insurance companies and other financial firms subject to Federal Reserve umbrella regulatory oversight. Although bank/commercial combinations continued to be prohibited, financial holding companies were authorized to engage in merchant banking.

The Bank Holding Company Act is significant for two additional reasons. Until interstate banking was legalized in 1994, the Douglas Amendment allowed each state to opt to permit out-of-state bank holding companies to acquire banks within its jurisdiction, providing an avenue for geographical diversification by bank holding companies. And the *Bank Holding Company Act Amendments of 1970* created the special antitying rules that prohibit banking organizations from directly or indirectly conditioning the sale of one financial product on the buyer's purchase of a second product from the bank.

The Banking Act of 1933 created much of the modern 'special' regulation of the banking industry, including (1) the separation of commercial and investment banking (Glass-Steagall), (2) the creation of the federal deposit insurance program, (3) the prohibition on deposit-taking by unlicensed financial or non-financial businesses, and (4) the ceilings on interest rates payable on bank deposit accounts. Although interest rate ceilings disappeared in the 1980s and Glass-Steagall's prohibitions on bank/securities affiliations and management interlocks were repealed in 1999, key parts of the statute remain law, and all of its regulations profoundly influenced the structure of the modern US banking industry and financial markets.

The Community Reinvestment Act of 1977 requires insured depository institutions (banks and thrifts) to help to meet the credit needs of the local communities in which they are located, especially low and moderate income neighborhoods. Although the statute does not contain any specific lending targets, federal bank and thrift regulators consider an institution's community lending record when deciding applications for mergers, acquisitions, branch openings or relocations and assign a community lending rating to all institutions that they supervise, which ratings are made public.

The Depository Institutions Deregulation and Monetary Control Act of 1980 increased federal deposit insurance coverage to $100 000 per insured account and began the deregulation of interest rates payable on time deposits, with the aim of making bank deposits more competitive with higher yielding non-bank investments such as money market mutual funds offered by securities firms.

The Federal Deposit Insurance Act now contains all regulation pertaining to the federal deposit insurance fund and the Federal Deposit Insurance Corporation, the agency that administers the insurance system and acts as chief federal regulator of state-chartered insured banks that are not members of the Federal Reserve system.

The Federal Deposit Insurance Corporation Improvement Act of 1991 made several important changes to bank failure policy, notably, limiting the discretion of the federal banking agencies to arrange dispositions of troubled banks that result in the protection of uninsured depositors. The statute also mandated the prompt closing and liquidation of undercapitalized banks and limited the Federal Reserve's ability to keep ailing banks afloat by making long-term liquidity loans. The statute was a rare modern instance of congressional reregulation, adopted in response to the costly failures that had weakened the bank and thrift industries in the 1980s. It took aim at the business of deposit brokerage, imposing new interest rate ceilings on deposits solicited through professional brokers, and temporarily halted state bank diversification into insurance and other new markets by limiting the non-banking powers of insured state-chartered banks to those available to national banks.

The Federal Reserve Act, which established the Federal Reserve system consisting of the centralized Federal Reserve Board and regional Federal Reserve banks and made the Federal Reserve chief federal regulator of member state-chartered banks, also contains Sections 23A and 23B that limit funds transfers and other financial transactions between insured banks and their non-bank affiliates.

The Foreign Bank Supervision Enhancement Act of 1991 strengthened US regulatory oversight of non-US banks doing business in the US, giving the Federal Reserve supervisory authority and requiring all US offices of non-US banks to meet uniform financial, management and operational standards equivalent to those imposed on US banks. It also prohibited the US branches of non-US banks from accepting retail insured deposits.

The Garn-St Germain Depository Institutions Act of 1982, although continuing the deregulation of bank deposit markets begun in 1980, also removed the Federal Reserve's discretion under the Bank Holding Company Act to decide that general insurance activities were closely related to banking and therefore permissible for bank holding company affiliates. This change in the law restricted the ability of the Federal Reserve to expand the insurance powers of banking organizations until 1999, when Congress permitted affiliations between banks and insurers.

The Glass-Steagall Act is the common name for those provisions of the Banking Act of 1933 that separated commercial (deposit) banking from investment (merchant) banking. Best known was Section 20, barring affiliations between banks and firms engaged principally in corporate securities underwriting and dealing, which was interpreted by the Federal Reserve in the 1980s to permit bank holding companies to establish securities affiliates to engage in limited amounts of corporate securities underwriting. Section 20 was repealed in 1999 along with Section 32's ban on management interlocks between banks and securities firms. Section 16 continues to prevent banks from directly underwriting securities, with exceptions for US government and municipal securities. (Banks may engage in broader securities activities through subsidiaries.) Section 21 continues to limit deposit-taking to licensed banks.

The Gramm-Leach-Bliley Act in 1999 repealed Glass-Steagall's ban on affiliations and management interlocks between banks and securities firms and also permitted affiliations between banks, insurance companies and other financial firms. The preferred organizational structure for conglomeration was the financial holding company, whose separate affiliates are subject to functional regulation by their respective bank, securities and state insurance supervisors, with the Federal Reserve acting as consolidated home country regulator. Diversified securities firms that do not own bank affiliates may opt for the Securities and Exchange Commission as their consolidated supervisor. National banks may diversify through financial subsidiaries into most financial businesses open to financial holding companies, except insurance underwriting, real estate and, temporarily, merchant banking.

To the extent that the Act ratified past regulatory and market innovations, such as the 1998 Travelers/Citicorp merger, it was not expected to transform US markets. Nevertheless, by removing remaining regulatory restrictions on financial combinations, the Act made diversification easier, which was likely to accelerate the pace of financial conglomeration and encourage entry into US markets by non-US financial firms. At the same time, however, some significant regulatory barriers remain, including restrictions on inter-affiliate funds transfers and transactions between bank and non-bank financial operations. Moreover, the Act strengthens enforcement of the Community Reinvestment Act against diversified banks and requires financial regulators to develop new privacy rules to prevent misuse or disclosure of personal financial information about retail bank consumers.

The International Banking Act of 1978 was designed to eliminate perceived regulatory advantages enjoyed by non-US banks operating in the US by subjecting those operations to US bank regulation. In the name of competitive equality, non-US banks doing business in the US were made subject to the same restrictions on diversification, including Glass-Steagall, and on geographical expansion that were applicable to US banks.

The McCarran-Ferguson Act of 1945 confirmed state autonomy over regulation of the insurance business by providing that no national law would preempt conflicting state insurance regulation unless the national legislation specifically related to the business of insurance. The reach of the statute became an issue in the 1990s when the Comptroller of the Currency, chief regulator of national banks, began to interpret national banking laws to permit national banks to act as insurance agents in contravention of state insurance regulation. The Supreme Court resolved this conflict in favor of the Comptroller, finding that the relevant provision of the national banking law did specifically relate to the business of insurance and therefore did not invoke the anti-preemption doctrine of McCarran-Ferguson. Today, McCarran-Ferguson still permits states to license and regulate insurance companies, including those affiliated with banks, so long as state regulation does not discriminate against banks or prevent them from conducting an insurance business.

The National Bank Act provides a national chartering option for banks. National banks are regulated by the Comptroller of the Currency, an official of the US Treasury Department, and may exercise the banking powers enumerated in the statute together with additional incidental powers authorized by the Comptroller of the Currency. In 1999, Congress authorized national banks to establish financial subsidiaries to engage in a broad array of financial activities, with the important exceptions of insurance underwriting, real estate and, for five years, merchant banking.

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 effectively ended most legal restrictions on interstate bank acquisitions and interstate branching. Previously, national law had deferred to state banking law, which, until the 1980s, had been hostile to interstate banking.

The Securities Act of 1933 provides for registration with the Securities and Exchange Commission of new public issues of securities by most corporations and the dissemination of information about the issuer to prospective investors. Banks, although not bank holding companies, were exempted from this scheme.

The Securities Exchange Act of 1934 provides for the registration and regulation of securities brokers and dealers and of national securities exchanges (like the New York Stock Exchange). In addition, companies with corporate securities traded on a national securities exchange or in the NASDAQ market are required to disseminate periodic public disclosure concerning their operations and financial position. By virtue of registration, securities brokers and dealers become subject to regulation by the Securities and Exchange Commission (although, as a practical matter, day-to-day supervision is the responsibility of the securities exchanges and the National Association of Securities Dealers, an industry group that functions as a self-regulatory organization). Originally, all banks were exempt from broker–dealer registration and regulation, but this exemption was significantly narrowed in 1999. Bank affiliates engaged in most securities activities must also register as broker–dealers.