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Recommended Citation

Jerry W. Markham, Banking Regulation: Its History and Future, 4 N. C. Banking Inst. 221, 286 (2000).

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BANKING REGULATION:
ITS HISTORY AND FUTURE

JERRY W. MARKHAM†

I. INTRODUCTION

The current regulatory structure for banking services in the United States is not the result of any grand design or reasoned blueprint. Instead, it represents a set of accumulated responses to a long history of financial crises, scandals, happenstance, personalities and compromises among a broad and competing array of industry and governmental units. This article will trace the history of the growth and regulation of banking services in the United States. That history will show how the existing regulatory structure was developed in response to demands of the Civil War and a populist crusade against the "money trust." That effort reached its zenith with the New Deal legislation of the 1930s, but began to fall apart as financial services consolidated. The article will then show how the financial services industries (banking, insurance, securities and derivatives) began to merge in their product base while at the same time separating on a fault line between institutional and retail customers.¹ After reviewing this history, the article will discuss the fu-

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¹ For the purposes of this article, financial services are defined to include banking, securities, derivatives and insurance. This definition is not exact. There are a broad array of financial services providers that do not fit precisely in such boxes, such as finance companies, installment sales financing operations, sub-prime lenders, payday cashing operations and even pawn shops. Sub-prime lenders, for example, provide loans to high risk borrowers, including individuals with prior credit problems. See Karen Hube, In the Wild West of Subprime Lending, Borrowers Have to Dodge Many Bullets, WALL ST. J., Mar. 18, 1998, at Cl; JOHN GUNTHER, SUB-PRIME MORTGAGE LOANS (Nov. 1997). Sub-Prime Funding Corp. General Information Website. Paycheck cashing operations are widespread in lower income areas. Such services are needed. In March of 1998, more than one in eight families in the United States did not have a bank
ture of banking regulation under the functional regulatory structure adopted by the recently adopted Gramm-Leach-Bliley Act for financial services holding companies.

II. THE BANKING INDUSTRY & ITS HISTORY

A. The "BUSes"

Banking in America and its regulation has a long and tangled history. Robert Morris, the Superintendent of Finance for the Continental Congress, laid the groundwork for the existing structure during the Revolution. Assisting Morris in that effort was Alexander Hamilton who, as a reader of Adam Smith's *The Wealth of Nations* that was published in 1776, became an advocate of a central bank that would guide and help build America into a world power.²

Hamilton proposed such an institution in a letter to Robert Morris that was written while the Continental Army was in winter quarters.\(^3\) Morris set that plan in motion through the "Bank of North America," which began operations in 1782 and aided the Continental army during some of its darker hours.\(^4\)

Alexander Hamilton, when he became the first Secretary of the Treasury, reported to Congress on measures needed to establish public credit in 1790. He recommended the creation of a "National Bank" that would become the "Bank of the United States."\(^5\) Hamilton used the Bank of England as the model for the creation of this bank.\(^6\) Hamilton wanted the Bank of the United States ("BUS") to be a private bank. Congress approved Hamilton's recommendations and authorized the creation of this national bank in 1791.\(^7\)

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3. See id. See also ALBERT S. BOLLES, THE FINANCIAL HISTORY OF THE UNITED STATES 92 (D. Appleton & Company 1896); BRAY HAMMOND, BANKS AND POLITICS IN AMERICA FROM THE REVOLUTION TO THE CIVIL WAR 41 (1957).


One critic has suggested that the contributions to the war effort by the Bank of America were small. See WILLIAM M. GOUGE, A SHORT HISTORY OF PAPER MONEY AND BANKING IN THE UNITED STATES INCLUDING AN ACCOUNT OF PROVINCIAL AND CONTINENTAL PAPER MONEY TO WHICH IS PREFIXED AN INQUIRY INTO THE PRINCIPLES OF THE SYSTEM (Part II) 32 (T.W. Ustick 1833).

5. See MOULTON, supra note 4, at 3. Hamilton's report asserted that "a National Bank is an institution of primary importance to the prosperous administration of the finances, and would be of the greatest utility in the operations connected with the support of the public credit." See A. BARTON HEPBURN, HISTORY OF COINAGE AND CURRENCY IN THE UNITED STATES AND THE PERENNIAL CONTEST FOR SOUND MONEY 624 (1968).

6. See HAMMOND, supra note 3, at 3.

7. The chartering of the Bank of the United States created a controversy over whether Congress had such an implied power under the constitution. The cabinet of George Washington split on that issue. Thomas Jefferson, James Madison and Edmund Randolph were opposed, while Alexander Hamilton and General Henry Knox, the Secretary of War, were in favor. Jefferson, in particular, was staunchly against the chartering of the Bank of the United States. He believed that "banking establishments are more dangerous to our liberties than standing armies." See WILLIAM F. HIXSON, TRIUMPH OF THE BANKERS, MONEY AND BANKING IN THE EIGHTEENTH AND NINETEENTH CENTURIES 94 (1993). Apparently convinced by Jefferson's arguments, President Washington asked Madison to prepare a veto message on the bank legislation. But Washington did not issue that message. Instead, he accepted Hamilton's views and allowed the bank to be chartered. See JOSEPH STANCLIFFE DAVIS, ESSAYS IN THE EARLIER HISTORY OF AMERICAN CORPORATIONS 12-14 (1965); JAMES W. GILBART, THE HISTORY OF BANKING
BUS was not the only bank in America. A number of banks were created in the years following the Revolution. Between 1782 and 1837, over 700 banks sprang up in the United States.  

Since there was no national currency, the notes issued by the banks began circulating as a substitute. It was sometimes an unstable currency. As John Adams noted in 1799, "the fluctuations of our circulating medium have committed greater depredations upon the property of honest men than all the French piracies." The states began to take some rudimentary efforts to regulate banking. Massachusetts and New Hampshire prohibited unincorporated banks in 1799. New York imposed a similar measure in 1804. These prohibitions were based on the English Bubble Act of 1720, which had sought to curb speculative enterprises by requiring businesses to obtain a government approved charter before stock could be sold to the public or notes issued.

Despite the competition, the BUS continued as the premier bank. It had branches in Boston, New York, Washington, Norfolk, Charleston, Savannah and New Orleans. Ironically, the success of the BUS spelled its doom. It was a threat to the state banks that were appearing in ever increasing numbers, and Congress refused to renew its charter in 1811. The expiration of the bank's Congressional charter created a vacuum that was soon filled by the state banks. Over 120 new state banks were chartered between 1811

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11. See Hammond, supra note 3, at 159. See also Gilbert, supra note 7, at 42. Bank failures were beginning to surface as another threat to the system. Apparently, the first bank to fail in the United States was in Rhode Island in 1809. See Klebaner, supra note 10, at 48.
13. See Remini 1, supra note 7, at 139.
14. See id.
and 1815. Difficulties encountered during the War of 1812, however, resulted in the creation of a new Bank of the United States. The states did not react favorably toward this institution. Fourteen states passed laws that tried to prevent the second BUS from collecting its debts. Six states tried to tax the branches of the second BUS in their borders. In *McCulloch v. Maryland*, however, the Supreme Court held that a Maryland tax directed against BUS violated the Constitution. That ruling freed BUS from restrictive state regulations.

A panic in 1819 was blamed by some on the BUS's conservative lending practices. The Bank engendered further hostility when it foreclosed on large amounts of real estate after the panic. The appointment of Nicholas Biddle as President of the BUS in 1823 restored its stature. Biddle pursued an aggressive program of expansion, and the BUS had twenty-five branches by 1830. The BUS was then making profits of more than $3 million a year. It was conducting some twenty percent of banking business in the United States.

The BUS became the center of a political battle that has reverberated through the centuries. Andrew Jackson viewed the bank to be a "monster." Henry Clay, his political rival, wanted to make the BUS's charter a political issue to further Clay's own Presidential

15. *See Bolles, supra* note 3, at 261.
17. *See Remini 1, supra* note 7, at 198.
18. 17 U.S. 316 (1819).
19. *See* Kinley, *supra* note 12, at 19. The panic in 1819 brought "a catastrophe that sent cotton prices tumbling, plunging merchants and planters into bankruptcy, drying up credit, and spreading despair and suffering through every level of society." *See Robert Leckie, From Sea to Shining Sea, From the War of 1812 to the Mexican War, The Saga of America's Expansion* 497 (1993).
24. *See* M. Grace Madeleine, Monetary and Banking Theories of Jacksonian Democracy 41-42 (1943).
ambitions. Clay and his supporters, who included Daniel Webster, had control of both the House and the Senate. They rechartered the Second Bank in 1832. Jackson responded by vetoing that legislation. His veto was upheld, and he ordered the government's deposits to be removed from the BUS to state banks that were politically aligned with Jackson. They were derisively referred to by Jackson's opponents as the "pet" banks. At Clay's urging, Jackson was censured by the Senate for his removal order, but Clay suffered a severe defeat when the Senate voted to expunge that censure from Senate records in 1837.

B. After the "BUSes"

The struggle over the BUS set back the effort to create a central banking authority until the next century, and its demise led to a "bank mania." The number of state banks more than doubled between 1829 and 1837. New York furthered their growth by allowing banks to be incorporated without requiring a special charter

26. See A.S. Colyar, Life and Times of Andrew Jackson 646 (1904). See generally, Remini 1, supra note 7, at 397-9. Thomas Hart Benton, whose financial background included service as a bank director and an expulsion from the University of North Carolina for stealing, was Jackson's strongest Senate supporter in the struggle over the BUS. See Leonard C. Helderman, National and State Banks: A Study of Their Origins 40 (1931); Sellers, supra note 16, at 290.
27. See Gilbert, supra note 7, at 20.
28. See Bassett, supra note 20, at 631; Klebaner, supra note 10, at 44. The pet banks of Andrew Jackson initially numbered seven but were increased to twenty-two by the end of 1833 and to ninety over the next three years. See Robert V. Remini, The Life of Andrew Jackson 264 (1988); Robert V. Remini, Daniel Webster, The Man and His Time 400, n. 7 (1997).

Federal legislation was passed in 1846 that created an independent Treasury system. See Kunley, supra note 12, at 50. Jackson's pet state banks were then replaced by a number of sub-treasuries. See Ellis Paxson Oberholtzer, Jay Cooke: Financier of the Civil War 81 (1907); Bray Hammond, Sovereignty and an Empty Purse, Banks and Politics in the Civil War 20, 23 (1970).
30. See Madeleine, supra note 24, at 69.
31. See MacDonald, supra note 29, at 117.
from the legislature. Several other states followed this "free banking" approach to chartering. More affirmative regulation was also being adopted. New York set up a bank supervisory authority in 1829, and a more formal banking commission was created in New York to oversee banks after the Panic of 1837. Reserve requirements were imposed. The first insurance for bank depositors appears to have been developed by the New York safety fund law that was passed in 1829. It was not successful.

By the time of the Civil War, America's principal currency was the bank notes that were being issued by the state banks, which fluctuated in value according to their quality. Thousands of bank notes were then in circulation, many of which were counterfeit.


33. After the Panic of 1837, several states adopted legislation that made bank stockholders liable for twice the amount of the par value of their shares in the event of a bank's failure. This was double liability. See Report of the Monetary Commission of the Indianapolis Convention 240-41 (U. Chicago Press 1898). New York adopted such a measure in 1846. See Henry Clews, Twenty-Eight Years in Wall Street 84-85 (J. S. Ogilvie 1887). Double liability would also be included in the National Banking Act that was passed during the Civil War. See Helderman, supra note 26, at 154. See generally Jonathan R. Macey & Geoffrey P. Miller, Double Liability of Bank Shareholders: History & Implications, 27 Wake Forest L. Rev. 31 (1992) (providing analysis of the double liability standard of bank shareholders between the 1860's and the 1920's).

34. The banking commission was authorized to inspect banks chartered in New York four times a year. See Van Fennemaker, supra note 8, at 15-16; Klebaner, supra note 10, at 41.

35. See Knox, supra note 22, at 419; Larry E. Schweikart, Banking in the American South, 1836-1865 126-127 (1983) (unpublished Ph.D. dissertation, University of California) (on file with the University of California Library). States began requiring banks to report on their financial positions in the early 1800s. See Klebaner, supra note 10, at 41. Massachusetts passed such a statute in 1803. See Knox, supra note 22, at 360. The New York legislature required its banks to make semi-annual reports on their condition in 1838. Five years later, quarterly reports were required. See Report of the Monetary Commission of the Indianapolis Convention 357 (U. Chicago Press 1898).


37. See Klebaner, supra note 10, at 23.

The Union government created the "greenback" and made it legal tender as a way to fund its expenditures during the Civil War.\textsuperscript{39} This became our national currency, and the creation of the national banks was closely tied to its success.\textsuperscript{40} The federal government's elimination of state bank notes as a currency was accomplished through a two-step process. The first step was to create a national banking system. The second step was to tax the state bank notes out of existence. The first of these measures was taken with the passage of the National Banking Act that became law on February 25, 1863.\textsuperscript{41} It authorized the creation of "national" banks that would be regulated by the federal government. The Office of the Comptroller of the Currency was directed to administer this legislation.\textsuperscript{42} This resulted in a "dual" system of banking regulation between the states and the federal government.\textsuperscript{43}

C. The Birth of the Fed

The bank clearing houses were a key part of the banking sys-

\textsuperscript{39} See John Thompson's Bank Note Detector was one of the more popular of these services. See John Donald Wilson, The Chase: The Chase Manhattan Bank, N.A., 1945-1985 9 (1986) [hereinafter Wilson]; Oberholtzer, supra note 29, at 344.

\textsuperscript{40} See Bray Hammond, Sovereignty and an Empty Purse, Banks and Politics in the Civil War 239 (1970).

\textsuperscript{41} The greenback was made "legal tender" in order to assure its acceptance. The Supreme Court considered the legality of this requirement after the Civil War in the so-called "legal tender" cases. In Hepburn v. Griswold, 75 U.S. 603 (1869), the Court held that the legal tender requirement was unconstitutional. The Chief Justice who wrote the majority opinion for the Court in the Hepburn case was none other than Salmon P. Chase, the former Secretary of the Treasury who had administered the introduction of the greenbacks and the legal tender requirement into the American economy during the Civil War. Later, after a change in Justices and a little Court packing, the Attorney General of the United States sought argument on the legal tender issue once again in a case entitled Knox v. Lee, 79 U.S. 457 (1870). In a five to four decision in that case, with Chief Justice Chase dissenting, the Supreme Court overruled its decision in Hepburn and held that the legal tender requirement could be properly imposed by Congress under the Constitution. See generally, Albert S. Bolles, The Financial History of the United States From 1861 to 1885 255-257 (Augustus M. Kelley 1969) (1886); Milton Friedman & Anna Jacobson Schwartz, A Monetary History of the United States, 1867-1960 47, n. 51 (1963).

\textsuperscript{42} See Bray Hammond, Sovereignty and an Empty Purse, Banks and Politics in the Civil War 25 (1970).

\textsuperscript{43} See Gilchrist & Lewis, supra note 32, at 99.

\textsuperscript{41} See Hepburn, supra note 5, at 541.
tem after the Civil War. They served in the place of a central bank. Clearinghouse certificates were used as a means of relieving temporary stringencies in the money supply. The value of the clearinghouse certificates proved themselves during the panics in 1873, 1884, 1890 and 1893. The federal government was also learning that its activities could affect money market conditions. By 1887, the government was intervening in the money markets to supply additional cash by buying bonds. In 1899, the Secretary of the Treasury began using the national banks as a means to stabilize the markets during times of uncertainty. The Secretary was seeking to act as a central banker, but had neither the resources nor the knowledge needed to implement such policies successfully.

The trust companies became popular at the turn of the century as a mechanism for avoiding the functional regulation that was being imposed on commercial banks. The Knickerbocker Trust

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44. The Suffolk Bank of Boston had created a clearing system in 1819 that sought to prevent state banks from over-issuing their bills. The Suffolk Bank agreed to redeem the bills of New England country banks at par, if those banks kept funds on deposit with the Suffolk Bank. See ARTHUR NUSBAUM, A HISTORY OF THE DOLLAR 67 (1957).

45. The original plan for the bank clearing house in New York was published in the Bankers Magazine in September of 1853. Sixty-two banks participated in its organization. See KNOX, supra note 22, at 423. Initially, the primary role of the clearing house was to exchange checks and drafts between the member banks and to settle balances resulting from those exchanges. See JAMES G. CANNON, CLEARING HOUSES, S. Doc. No. 61-491, at 11 (1910).

46. See S. Doc. No. 61-491, at 75.

47. See HEPBURN, supra note 5, at 349.

48. During the Civil War, the government or its agents periodically engaged in bond transactions to undermine speculators who were driving up gold prices. For example, after the assassination of Abraham Lincoln, Jay Cooke, the Union government’s principal bond salesman, was given carte blanche authority by the Treasury to support the market for government securities. He bought $20 million of bonds in a week and stopped a panic. Cooke was also later able to sell the bonds he had bought for a profit. See MEADE MINNINGERODE, CERTAIN RICH MEN 65 (1927). Even earlier, in 1791, Alexander Hamilton had tried unsuccessfully to support the securities market in New York during a panic by authorizing the purchase of $150,000 in government securities. See WARSHOW, supra note 2, at 144-145; JOHN STEELE GORDON, THE GREAT GAME, THE EMERGENCE OF WALL STREET AS A WORLD POWER 1653-2000 44 (1999).


51. The number of trust companies increased from seven in 1865 to over 250 in 1890. See HERMAN E. KROOSS & MARTIN R. BLYN, A HISTORY OF FINANCIAL INTERMEDIAR-
Company was the third largest trust company in New York with deposits in excess of $60 million when it failed on October 22, 1907.\textsuperscript{52} The Knickerbocker's failure touched off a panic that was one of the worst in the history of the United States.\textsuperscript{53} The federal government appeared to be helpless in dealing with the crisis. Instead, a single individual emerged as the country's savior. He was an unlikely, unappreciated, but well paid, hero. That individual, J.P. Morgan, acted as a “one-man Federal Reserve Bank” in stopping the panic.\textsuperscript{54} Even so, the country was left shaken and stunned by the suddenness and force of that economic catastrophe.\textsuperscript{55} Congress created a Monetary Commission to examine the causes of the Panic of 1907 and to propose measures to prevent such an occurrence in the future.\textsuperscript{56} The Commission was chaired by

\begin{footnotesize}
\begin{enumerate}
\item Some 50 trust companies were chartered in New York alone between 1870 and 1900. See H. Peers Brewer, The Emergence of the Trust Company in New York City, 1870-1900 263 (1986).
\item See James G. Cannon, Clearing Houses, S. Doc. No. 61-491, at 251 (1910).
\item See William O. Scroggs, A Century of Banking Progress 258-259 (1924).
\item Senator Nelson Aldrich later noted that “the country escaped by the narrowest possible margin from a total collapse of all credit and a wholesale destruction of all values.” Senator Nelson W. Aldrich, The Work of the National Monetary Commission, S. Doc. No. 61-406, at 3 (1909). Senator Aldrich stated that:

To the great majority of the people of the country the blow came without a warning. Most of our banking institutions were in excellent condition, business of every kind was prosperous, labor was fully employed at satisfactory wages, industries of every kind were flourishing. Our people were full of hope and confidence for the future. Suddenly the banks of the country suspended payment, and acknowledged their inability to meet their current obligations on demand. The results of this suspension were felt at once; it became impossible in many cases to secure funds or credit to move crops or to carry on ordinary business operations; a complete disruption of domestic exchanges took place; disorganization and financial embarrassment affected seriously every industry; thousands of men were thrown out of employment, and the wages of the employed were reduced.

\textit{Id.} at 3-4.

\item Congress initially focused on the “inelastic” money supply as a prime culprit in the Panic of 1908. That concern led to the enactment of the Aldrich-Vreeland Act of 1908, which established "National Currency Associations" that would provide relief in times of stringency. The National Currency Associations were to provide emergency liquidity by allowing banks to issue credit notes against deposits of commercial paper, as well as government bonds. See Cleveland & Huertas, \textit{supra} note 50, at 60; Davis Rich Dewey, Financial History of the United States 482 (1928); Thomas W. Lamont, Henry P. Davison 95 (1933).
\end{enumerate}
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Senator Aldrich. He conducted an extensive investigation that lasted almost four years. Senator Aldrich introduced legislation in 1912 that proposed the creation of such a central banking authority in the United States. Following much debate and various compromises, the Federal Reserve Act of 1913 was enacted. It created a further division in bank regulation. In addition to state regulation, federal bank regulatory authority was being split between the Treasury Department and the Federal Reserve System (the “Fed”). The Comptroller of the Currency at the Treasury retained responsibility for examining and regulating the national banks, while the Fed managed monetary issues.

D. Branch Banking

Another regulatory issue affecting banking was restrictions on branch banking. Branch banking was an established practice in the United States almost from the country’s inception, but branch banking by national banks was restricted under the National Banking Act. By 1895, branching was permitted in twenty states, but

57. Ostensibly the result of the Monetary Commission’s study, the bill had actually been written in a secret meeting of bankers at a millionaires’ club on Jekyll Island in Georgia where the participants arrived in a private rail car. Disguised as a group of wealthy duck hunters, they concluded that a federal banking system was needed to provide liquidity to the private banks in times of stress. The group eschewed a central bank that would be controlled by the government. Instead, they opted for a more decentralized system that would be controlled by private bankers, such as themselves. See RON CHERNOW, TITAN, THE LIFE OF JOHN D. ROCKEFELLER, SR. 375 (1998); LAMONT, supra note 56, at 97-99 (1933); JEAN STROUSE, MORGAN, AMERICAN FINANCIER 626 (1999); SCROGGS, supra note 53, at 280.

58. See KENDRICK A. CLEMENTS, WOODROW WILSON, WORLD STATESMAN, 113 (1987); DEWEY, supra note 56, at 491; KROESS & BLYN, supra note 51, at 180.

59. Despite concerns expressed by Alexander Hamilton with branch banking, the first Bank of the United States had opened several branches. The second Bank of the United States had twenty-five branches in 1830. See KLEBANER, supra note 10, at 13. Some 100 branches were being operated by banks in 1834; a number that swelled to about 175 branches in 1861. The State Bank of Ohio had 36 six branches at the outbreak of the Civil War. See id.

60. The second Comptroller of the Currency, Freeman Clarke, had ruled that national banks could not branch. See Donald C. Langevoort, Interpreting the McFadden Act: The Politics and Economics of shared ATMs and Discount Brokerage Houses, 41 BUS. LAW. 1265, 1266 (1986). State banks converting to national banks were allowed to maintain their existing branches but could not expand their number. Although the Comptroller of the Currency sought legislation at various times in the 1880s and early
most branch banks were intra-city branches, and eight of those states later prohibited branching. By 1896, thirteen states prohibited branch banking and many other states considered the practice to be illegal. Charles G. Dawes, Comptroller of the Currency, was among those who had come to oppose branch banking. He and other opponents were concerned that large banks would become too powerful. This was a reflection of the concern with the trusts and other large corporations that were developing at this time. The thought was that branch banking "would result in building up a money power which would crush the small banks out of existence." In one statement in Congress, it was claimed that "a choice must be made between one great United States Bank with ten thousand branches, and on the other hand ten thousand independent banks.""64

Between 1900 and 1902, several branch banking bills were introduced in Congress. That legislation failed as a result of opposition from the country banks who did not want that competition. At the end of the nineteenth century, only five national and eighty-two state banks had branches. In total, they had 119 branches.66

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61. See Fischer, supra note 12, at 33; Klebaner, supra note 10, at 60.
63. See Fischer, supra note 12, at 27.
64. See id. at 26-29. The Jeffersonian and Jacksonian schools of political thought had spawned the "populist" movement that was heavily agrarian in outlook and blamed many of mankind’s problems on the monied interests. This movement was reaching its peak at the turn of the century as the muckrakers were discovering that John D. Rockfeller and the other trusts were controlling vast amalgamations of wealth. Congressman Charles Lindbergh of Minnesota, the father of the famous flyer, convinced Congress in 1911 to investigate the financial markets. See A. Scott Berg, Lindbergh 34-36 (1998). Lindbergh, who was given credit for creating the “money trust hunt” by Ida Tarbell, claimed that a “money trust” was controlling American finance “in restraint of trade.” See James Grant, Money of the Mind, Borrowing and Lending in America From the Civil War to Michael Milken 124 (1992); Cleveland & Huertas, supra note 50, at 67. The resulting investigation targeted J.P. Morgan. The House Committee on Banking and Currency uncovered some startling evidence as to just how much control Morgan exercised over Wall Street. See id. See also Margaret G. Myers, A Financial History of the United States 253-254 (1970).
Opposition to branch banking was at first scattered but was growing after the twentieth century began. The American Bankers Association was a firm opponent of branch banking. It adopted a resolution in 1916 against branches, and a similar resolution was passed in 1922. The Comptroller of the Currency was seeking legislation to limit branch banking because of his concern that unlimited branch banking would mean the destruction of the national banking system. Despite that opposition, by 1920, the number of branch banks had increased substantially. Branch banks then held some fifteen percent of loans and investments of commercial banks. In 1923, there were 91 national and 580 state banks that had a total of over 2,000 branches. Branches outside of home office areas began to increase further in 1925. Even then, the trend was to prohibit or tightly restrict branch banking. This resulted in "unit" banking in the United States, i.e., single bank units. These individual banks established correspondent banking arrangements with other banks in order to conduct interstate or even inter-city banking transactions. The correspondents borrowed from each other and referred business outside their geographical area. Most country banks were strongly dependent on their correspondent banking relationships in New York, which was the nation's money center by the time of the Civil War. Nevertheless, correspondent banking frustrated efforts by the city banks and their clearinghouses to stabilize liquidity during times of panic because the country banks

67. See Fischer, supra note 12, at 43, 45.
69. See Fischer, supra note 12, at 34. California was the most liberal in allowing branch banking. Some 80 banks in that state had over 475 branches. The branch bank leader was Amadeo Giannini, who had a chain of 24 banks in California by 1918. See Alex Groner, The American Heritage History of American Business & Industry 284 (1972).
70. See First Nat'l Bank of Logan, 385 U.S. at 257.
71. See Fischer, supra note 12, at 38. Groups of "chain" banks were operating in the United States, i.e., banks that were jointly owned. They were limited in their operations until state statutes were amended to allow holding companies. See id. at 75-76.
72. See James, supra note 62, at 90.
73. See id. at 121.
74. See Klebaner, supra note 10, at 71.
75. See James, supra note 62, at 95-96.
would withdraw their deposits in times of trouble.\textsuperscript{76}

The McFadden Act that was adopted in 1926 sought to allow national banks to establish branches under conditions similar to those permitted by state banks.\textsuperscript{77} The McFadden Act provided for the creation of new branches by national banks in states that permitted banks to have branches and in cities with a population of more than 25,000.\textsuperscript{78} Actually, “[t]he ultimate effect of the McFadden Act was to allow state legislators and regulators to prevent out-of-state banks from opening branches within their borders.”\textsuperscript{79} This assured that small communities would only be served by their local banks. They would be spared the competition and services of the larger and better capitalized big city banks. More significantly, restrictions on branch banking resulted in a large number of very weak banks that would be unable to cope with a serious economic downturn.\textsuperscript{80}

E. Monetary Policy

The Fed found itself struggling with monetary policy almost from its inception. The country experienced an expansion after World War I that the Fed tried to slow.\textsuperscript{81} At the same time, farm commodity prices were falling, and a “commodity or inventory panic” resulted in a recession in the farm belt.\textsuperscript{82} The economy recovered by 1923, and it was thought that the Fed had stabilized the


\textsuperscript{77} See SCROGGS, supra note 53, at 319. Before the enactment of McFadden Act, the national banks were still limited to one bank office, but they could have branches in the city in which they were located. See RONALD P. Auerbach, \textit{HISTORICAL OVERVIEW OF FINANCIAL INSTITUTIONS IN THE UNITED STATES} 20 (1979). Such branches could only accept deposits and pay out funds. See SCROGGS, supra note 53, at 317.

\textsuperscript{78} See Financial Institutions and the Nation’s Economy (FINE), Discussion of Principles, Committee on Banking, Currency and Housing, H.R. Rep. 94th Cong., 2d Sess. (committee print) 146 (June 1976); KROOS & BLYN, supra note 51, at 160 (1971).


\textsuperscript{81} See CLEVELAND & HuERTAS, supra note 50, at 104-105.

\textsuperscript{82} See United States v. Morgan, 118 F. Supp. 621, 641 (S.D.N.Y. 1953).
situation and prevented a panic in the financial markets. This “led many to believe that this nation . . . [had] undergone its last money panic” and that the Fed could safely guide the economy during troubled times. Critics claimed that the Fed actually did little to alleviate the recession in the farm belt.

Another problem was a power struggle in the Federal Reserve System. This internecine fight was the result of efforts by the New York Federal Reserve Bank to gain prominence over the other Reserve Banks in the system. The other Reserve Banks were resisting New York’s dominance over monetary policy and were sometimes pursuing their own open market policies. This fight for control would have grave consequences in the events that led to the stock market crash of 1929. The Fed sought to curb stock market speculation beginning in 1928, but was frustrated by disputes with the New York Federal Reserve Bank where Charlie Mitchell, the President of the National City Bank (later Citibank), was appointed as a director in 1929. After the Fed sought to restrict credit in 1929, Mitchell announced that the National City Bank would loan $25 million into the call money market to provide liquidity. Its af-

83. See SCROGGS, supra note 53, at 309-310.
84. Id. at 310.
86. See H.R. DOC. NO. 92-1, at 1-2.
87. See D’ARISTA 1, supra note 85, at 4.
88. New York’s position in this debate was due not only to role as the leading city of finance, but also to the fact that Governor Benjamin Strong of the New York Federal Reserve Bank had been both domineering and persuasive. Strong died in 1928, and this led to a diminishment of the New York Federal Reserve Bank’s authority on the Open Market Investment Committee. His death, however, came too late to affect the policies that would then seeking to deal with the frenzied speculation occurring in the stock market. See H.R. DOC. NO. 92-1, at 1-2.
89. See JOHN KENNETH GALBRAITH, THE GREAT CRASH 1929 38 (1988). Mitchell stated that his bank would make those loans, “whatever might be the attitude of the Federal Reserve Board.” Mitchell asserted that the National City Bank would make $5 million available when call rates went to 16% percent and would add another $5 million each time the rate rose one point. At that time, the First National Bank was borrowing money from the Fed and using that money to make call loans. See GRANT, supra note 64, at 193.
filiate, the National City Company was the nation's largest distributor of securities at that time. Senator Carter Glass of Virginia was incensed by Mitchell's announcement. The Senator demanded Mitchell's resignation as the director of the New York Federal Reserve Bank. This and other disputes with the New York Federal Reserve Bank "largely paralyzed monetary policy during almost the whole of the important year 1929."

F. The New Deal

Bank failures reached epidemic proportions after the stock market crash of 1929. In December of 1930, the Bank of United States failed. It was the largest bank failure in history at that time, but there were many joining it. By 1932, one in four banks in the United States had failed. Franklin Roosevelt was sworn in as President during the bank panic that struck America. He declared a national bank holiday on March 6, 1933, and new legislation was enacted to strengthen the banking system. Federal insurance was created to protect customer bank deposits and to maintain faith in the banks in order to prevent depositor runs. This insurance was to be administered by the Federal Deposit Insurance Corporation ("FDIC").

The Glass-Steagall Act sought the "complete divorcement" of commercial and investment banking. There is still uncertainty as

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90. See CLEVELAND & HUERTAS, supra note 50, at 107, 132.
92. FRIEDMAN & SCHWARTZ, supra note 40, at 255.
93. See id. at 309-310.
95. See MICHEL BEAUD, A HISTORY OF CAPITALISM, 1500-1980 159 (1983).
96. See Auerbach, supra note 77, at 19.
98. S. REP. NO. 73-1455, at 185 (2d Sess. 1934). Commercial banks were prohibited
to why Congress mandated such an approach. Presumably, it was due to the failure of the Bank of United States and its securities affiliate—the City Financial Corporation. The affiliate, however, was not shown to have caused the bank's failure. The real reason for this legislation may have been Congressional annoyance with Charles Mitchell and the National City Co., the securities affiliate of the National City Bank. Mitchell's defiance of the Federal Reserve Board's efforts to curb call money before the crash was certainly intended to benefit his bank's security affiliate, the National City Co. It also angered Senator Glass.

G. The Market Knocks on the Regulatory Door

The Fed only slowly grasped the reigns of control over monetary policy. That agency was accused of pushing the country back from engaging in the “issue, flotation, underwriting, public sale or distribution either wholesale, or retail or through a syndicate participation, of stocks, bonds, debentures, notes or other securities.” See Twentieth Century Fund, Inc., The Security Markets 84 (1935).

99. See Grant supra note 64, at 203-210. A Fed official testified during the Glass-Steagall hearings that, while there had been abuses with the bank affiliates, the Board did not advocate prohibiting banks from having securities affiliates. See David Saul Roberts, Regulating the Securities Industry: The Evolution of a Government Policy 73 (1969) (on file with author).

100. After the Comptroller of the Currency ruled in 1902 that a national bank could not act as an investment bank in underwriting securities, the larger national banks began forming affiliates to act as securities dealers. The National City Company was formed by the National City Bank. See S. Rep. No. 73-1455, at 157 (1954). On November 6, 1911, Frederick W. Lehman, the Solicitor General of the United States, rendered an opinion to the Attorney General in which the Solicitor opined that the creation of the National City Co. violated banking laws. See George W. Edwards, The Evolution of Finance Capitalism 193 (1967). The National City Bank ignored that ruling. The Attorney General then adopted the Solicitor's opinion and was prepared to mount a formal challenge to the subsidiary as being in violation of the national banking laws. The Secretary of the Treasury, however, took the opposite position. See Cleveland & Huertas, supra note 50, at 62-66. President William H. Taft then decided to let the issue die. See id. at 66-67.

101. Senator Glass stated that the Federal Reserve System had been transformed into an “investment banking system” while the purpose of the Fed was to create a commercial banking system free of speculation. Glass was concerned that a member bank could engage in speculative operations and then, when its reserves were impaired, take eligible paper for rediscount and use the additional funds for more speculation in a “roundabout way.” See R. Nicholas Rodelli, Note, The New Operating Standards for Section 20 Subsidiaries: The Federal Reserve Board’s Prudent March Toward Financial Services Modernization, 2 N.C. Banking Inst. 311, 313 n. 17 (1998).
into recession in 1937 by its restrictive policies. The Fed was also forced to bow to the Treasury Department on issues of monetary policy during World War II. In order to reduce government costs caused by that conflict, the Treasury Department decreed that interest rates would be kept at artificially low levels. The Fed agreed to that policy until post-war inflation became more of a threat than high government borrowing costs. Friction between the Fed and the Treasury on this issue increased until the adoption of the so-called “Treasury-Federal Reserve Accord” that was entered into by the Fed and the Treasury in March of 1951. The agreement strengthened the role of the Fed in managing federal monetary policy.

The Fed's Regulation Q restricted interest rates paid on time deposits by national banks. Because of Regulation Q, banking was not viewed to be a very complicated business in the 1950s. It was claimed that bankers operated on a “3-6-3” rule. This meant that the bankers borrowed money at the Regulation Q interest rate of three percent and loaned the money at six percent. The bankers were then free to play golf by three o’clock, since there was nothing else to do. Advertising premiums were offered in the 1950s for new business. This allowed banks to avoid Regulation Q ceilings. Toasters and other giveaways were used to attract depositors to these programs.

The 1960s marked the beginning of an era in which financial service firms sought to expand and diversify their businesses across regulatory boundaries. James J. Saxon, who was appointed by

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103. See Friedman & Schwartz, supra note 40, at 625-626.
106. See Wilson, supra note 38, at 81.
President Kennedy to the position of Comptroller of the Currency, sought to open the door to such diversification to the banks. Saxon and his successors took an expansive view of the banking laws in allowing the banks to broaden their business base. Saxon's rulings upset a delicate balance between the banking and other financial service industries. He started an effort that continues today to remove restrictions on banks that prevent them from aggressively expanding their business activities. The rulings of the Comptroller were challenged in court by competitors and were sometimes stricken down, but the effort to ease restrictions on bank activities continued.

The banks began looking for other loopholes to expand their business and avoid banking regulations. The Bank Holding Company Act of 1956 restricted the ability of bank holding companies to enter into other lines of business or to purchase other banks. Such activities required Fed approval, but the Bank Holding Company Act of 1956 did not apply to one-bank holding companies. The number of one-bank holding companies grew rapidly as this loophole was exploited. These entities held about one third of total bank

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110. See id. at 280.
111. See 2 Jane W. D’ARISTA, THE EVOLUTION OF U.S. FINANCE, RESTRUCTURING INSTITUTIONS AND MARKETS, at 69 (1994) [hereinafter D’Arista 2]. Among other things, the Comptroller ruled that national banks could make data processing services available to other banks and to bank customers and that such activities were incidental to their banking services. That decision was appealed to the Supreme Court. See Association of Data Processing Serv. Organizations, Inc. v. Camp, 397 U.S. 150 (1970). The Comptroller announced in 1962 that national banks would be permitted to act as agents for insurance sales, but that action was overturned by the federal appeals court for the Fifth Circuit. See Saxon v. Georgia Ass’n of Indep. Ins. Agents, 399 F.2d 1010 (5th Cir. 1968). The Comptroller ruled in 1963 that a national bank could accept savings accounts from a corporation. The Federal Reserve Board, however, then asserted that such deposit had to be treated as a “time deposit.” Otherwise, it would be a demand deposit on which the payment of interest would be prohibited. This resulted in a highly publicized dispute between the two agencies. See Howard H. Hackley, OUR BaffLING BANKING SYSTEM, 52 VA. L. REV. 565, 618-620 (1966). In another ruling, the Comptroller concluded that providing travel services to customers was incidental to the business of banking and was a permissible activity for national banks. That action was overturned by the Supreme Court. See Arnold Tours, Inc. v. Camp, 400 U.S. 45 (1970).
112. See AUERBACH, supra note 77, at 31.
113. See supra note 111, at 69.
deposits. This concerned Congress, and it acted to close the one bank holding company exception through the Bank Holding Company Act Amendments of 1970.

H. Competition Bites

As inflation increased, the Fed's interest rate ceilings began to interfere with the ability of the banks to attract deposits. Credit "crunches" were occurring in which loan demand was outstripping the amount of funds banks had available to lend. The banks were seemingly helpless in dealing with these crunches. They could not attract sufficient deposits to meet loan demand at Regulation Q rates. This gave rise to a growing concern with "disintermediation" in which funds were being drawn from deposit institutions such as banks and savings and loan associations ("S&Ls") and invested in other investments such as securities. One source of competition

114. See id. Chase Manhattan Bank was among those forming a one-bank holding company. See WILSON, supra note 38, at 187. The First National City Bank also formed a one-bank holding company called CitiCorp. Numerous conglomerates were acquiring or creating one-bank holding companies, including Montgomery Ward, Baldwin Piano and even S&H Green Stamps. Leasco Data Processing Equipment Corporation even tried to acquire the Chemical Bank in New York through a one-bank holding company arrangement. See D'ARISTA 2, supra note 111, at 69-70.


116. Citibank ran into trouble with the Fed in 1980 when it gave away toasters and appliances in order to attract deposits at Regulation Q rates. The Fed had limited such gifts to amounts of between ten and fifty dollars based on the amount of the deposit. Citibank's "gifts" were exceeded those limitations, and it was fined $350,000 as punishment for this heinous crime. See ZWEB, supra note 107, at 673-674.

117. See MYERS, supra note 64, at 390-391. President Nixon created a Commission on Financial Structure & Regulation in 1970 that was chaired by Reed O. Hunt. The Hunt Commission recommended that limits on interest rates on deposits be abolished for accounts of more than $100,000 and that such rates should be used only on a standby basis for smaller accounts. See The Report of the President's Commission on Financial Structure & Regulation (Dec. 1971). The House Committee on Banking, Currency and Housing began a study in 1975 entitled "Financial Institutions and the Nation's Economy." ("FINE"). It sought to provide a basis for restructuring the regulation of banking and other deposit institutions. The FINE study asserted that "[a]rtificial ceilings on interest rates paid to depositors reduce the incentive for Americans to save, discriminate against small savers, and have not succeeded in preventing disintermediation." The FINE study proposed that a Federal Depository Institutions Commission be created and that all Regulation Q limits on interest rates be eliminated, along with the prohibition against paying interest on demand deposits. See H.R. Rep. No. 94-242 (1975); H.R. Rep. No. 94-241 (1975) (Discussion of principles).
for funds was the money market funds.\textsuperscript{118} In June of 1976, money market funds held less than $3 billion.\textsuperscript{119} By December of 1982, over $230 billion was held in money market funds at broker-dealers.\textsuperscript{120} Those money market funds became substitutes for bank accounts and allowed consumers to earn market rates on their liquid funds.\textsuperscript{121}

The banks turned to NOW accounts, negotiable CDs, Eurodollars, Eurobonds and other sources for funds.\textsuperscript{122} They also looked

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\item 118. Henry B.R. Brown and Bruce R. Bent invented the money market fund in 1971 in order to avoid the restrictions in Regulation Q that limited interest rates on bank deposits. \textit{See Zweig, supra note 107, at 363-364; Diana B. Henriques, Fidelity's World 196 (1995).} Actually, money market funds were not all that new. A New York Stock Exchange member firm, Henry Clews & Co., published advertisements in the \textit{New York Times} in 1896 announcing "[i]nterest allowed on deposit accounts." This seems to be a form of cash management account such as those made popular by Merrill Lynch in the 1980s. \textit{See N.Y. Times, Nov. 5, 1896, at 10.} In 1889, Howard Lapsley & Co. bought and sold stocks and bonds for cash "or on margin at the New York Stock Exchange." In addition, the firm stated in its advertisements that "Interest allowed on Deposits subject to Check at sight." \textit{Wall St. J., July 16, 1889, at 2.}


\item 120. \textit{See Zweig, supra note 107, at 774.}

\item 121. The Merrill Lynch Cash Management Account ("CMA") that was introduced in 1977 linked a Merrill Lynch money market fund with check-writing privileges. \textit{See Merrill Lynch, Annual Report 1985 14 (1986).} \textit{See generally, Peter Truell, The New Boss at Merrill Lynch, N.Y. Times, Dec. 20, 1996, at D1.} For a discussion and description of how the Merrill Lynch Cash Management Account worked in connection with a bank account at Bank One that was used for processing check and debit card transactions, see \textit{Martin Mayer, The Bankers, The Next Generation 90-92 (1997).}

\item 122. Turmoil in international finance and restrictions on United States banks resulted in the development of the "Eurodollar," i.e., time deposits of American dollars outside the United States whose maturity may vary from overnight to more than a year. \textit{See Ralph Nader's Study Group Report on First National Citybank, Citibank 307 (1972); Gordon L. Wolf \& Ian Davidson, The Gold War 44 (1970); Wilson, supra note 38, at 121.} Eurodollars were particularly popular because there were no interest rate ceilings on such deposits. \textit{See id. at 122.} \textit{See also, Prochnow \& Prochnow, supra note 108, at 100.} New Instruments were developed to take advantage of those deposits. One such device was the Eurodollar bond. \textit{See Institutional Investor, The Way It Was: An Oral History of Finance: 1967-1987 326, 569 (1988); Hal S. Scott \& Philip A. Wellons, International Finance, Transactions, Policy and Regulations 487, 654 (1995).}

The Consumer Savings Bank in Worcester, Massachusetts created the negotiable order of withdrawal ("NOW") account in 1972 as a means to compete with money market accounts. \textit{See Zweig, supra note 107, at 365.} A NOW account was essentially a checking account that paid interest, but the depository institution had the right to require prior notice of withdrawal since the withdrawal was technically coming from a savings account rather than a demand deposit account. \textit{See Board of Governors of the Fed. Reserve Sys. v. Dimension Fin. Corp., 474 U.S. 361 (1986).} NOW accounts also circumvented regulations preventing savings banks and S&L's from offering demand
elsewhere for profits. Foreign exchange operations grew, although not always without loss, as demonstrated by the failure of the Franklin National Bank and the Bankhaus Herstatt.\footnote{The Franklin's Bank's failure was, at that time, the largest bank failure in American history. See SAMPSON, supra note 32, at 132-135.} The latter's failure nearly caused a breakdown in the American CHIPS payment system.\footnote{Herstatt suffered losses of some $200 million from foreign exchange speculations before it collapsed. See KARL ERICH BORN, INTERNATIONAL BANKING IN THE 19TH AND 20TH CENTURIES 24, 27 (1983); ZWEIG, supra note 107, at 455.} Competition was causing the banks to make questionable loans. In 1975, non-performing loans at Chase Manhattan Bank were over $1.8 billion.\footnote{See WILSON, supra note 38, at 240.} That amount increased by another $400 million in 1976. Earlier, in 1974, the Secretary of the Treasury, George Schultz, announced that controls established ten years before on credit extensions by banks outside of the United States were being abolished.\footnote{See ZWEIG, supra note 107, at 388.} Thereafter, international lending grew faster than domestic lending for many banks.\footnote{See WILSON, supra note 38, at 284.} This business included large Latin American investments that would cause enormous losses. Years later, the largest banks in the United States were setting aside billions of dollars as loss reserves for loans to Latin America.\footnote{In August of 1982, Mexico announced that it could not meet its debt obligations, which totaled $85 billion. Mexico then nationalized its banks and declared a moratorium on the principal payments of its debt. See generally INSTITUTIONAL INVESTOR, THE WAY IT WAS, AN ORAL HISTORY OF FINANCE, 1967-1987 445, 448 (1988); BARRIE A. WIGMORE, SECURITIES MARKETS IN THE 1980s: THE NEW REGIME, 1979-1984 41 (1997). At that time, the nine largest American banks had Mexican loans that totaled 44% of their capital. See GREIDER, supra note 102, at 484. The United States put together a rescue package. See MARTIN H. WOLFSON, FINANCIAL CRISIS 90 (1994); ZWEIG, supra note 107, at 758. This did not stop the crisis. Mexico's problems were followed by defaults in Brazil, Argentina and more than 20 other countries. The 10 largest United States banks had $50 billion in loans to countries that were about to default at the end of 1982. See BARRIE A. WIGMORE, SECURITIES MARKETS IN THE 1980s: THE NEW REGIME, 1979-1984 41 (1997).} Deposits were becoming a smaller factor in banking. As banking expanded, and regulatory limits on interest payments squeezed out deposits, "borrowed money, rather than demand deposits were used to provide the fuel for bank growth."\footnote{See WILSON, supra note 38, at 2.} Restrict
tions on the ability of banks to expand their business base and Regulation Q restrictions on their ability to compete for funds was crippling the banking sector.\textsuperscript{130} American banks had dominated world finance beginning as early as World War I. By the middle of the 1970s, only four of the top twenty banks in the world were American.\textsuperscript{131} That number was reduced to three in 1979.\textsuperscript{132}

Large bank failures were occurring. To name a few, the National Bank of San Diego failed in December of 1973. It had almost $1 billion in deposits.\textsuperscript{133} The Bank of the Commonwealth in Detroit had to be rescued by the FDIC.\textsuperscript{134} The First Pennsylvania Bank, the oldest bank in the United States, was failing in April of 1980. The bank had used short term money to finance long term bonds. In order to rescue the First Pennsylvania Bank, a group of banks agreed to loan it $500 million and to extend a credit line of another $1 billion.\textsuperscript{135} Penn Square, which was operating out of a shopping center, failed in July of 1982.\textsuperscript{136} Continental Illinois Bank in Chicago held

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\item Competition was coming from other directions. Commercial firms and stock brokers began acquiring banks and turning them into non-bank banks that either accepted deposits or made commercial loans, but not both. These non-bank banks were not subject to banking restrictions. Gulf & Western acquired a California bank and sold its commercial loan portfolio so that it could become a non-bank bank and not be subject to the Bank Holding Company Act. J.C. Penney in 1983 did essentially the same thing when it bought a national bank and sold its commercial loans. Some of the brokerage firms operating non-bank banks were Merrill Lynch, E.F. Hutton, Paine Webber, Drexel Burnham, Lambert and Shearson Lehman/American Express. See D'ARISTA 2, supra note 111, at 88; ZWEIG, supra note 107, at 811. Under the definition of what constitutes a bank in the Bank Holding Company Act, a bank was an institution that was both accepting demand deposits and making commercial loans. The Fed tried to treat the non-banks as banks, but the Supreme Court rejected that effort in 1986. See Board of Governors of the Fed. Reserve Sys. v. Dimension Fin. Corp., 474 U.S. 361 (1986). Congress then intervened by adopting the Competitive Equality in Banking Act of 1987 that curbed the use of non-bank banks, by redefining "bank" in the Bank Holding Company Act. See D'ARISTA 2, supra note 111, at 88, 308, 369. Non-bank banks acquired before March 5, 1987 were grandfathered. See MICHAEL G. CAPATIDES, A GUIDE TO THE CAPITAL MARKETS ACTIVITIES OF BANKS AND BANK HOLDING COMPANIES 9, n.12 (1993).
\item See ZWEIG, supra note 107, at 446.
\item See GREIDER, supra note 102, at 26-27.
\item See H.R. Rep. No. 94-241, at 160 (1975); WOLFSON, supra note 128, at 56 (1994).
\item See IRVINE H. SPRAGUE, BAILOUT, AN INSIDER'S ACCOUNT OF BANK FAILURES AND RESCUES 83-54 (1986).
\item See INSTITUTIONAL INVESTOR, supra note 122, at 352 (1988); See ZWEIG, supra note 107, at 696-697.
\item See GREIDER, supra note 102, at 496. One of the loan officers at Penn Square
some $1 billion of oil and gas loans that had been originated by Penn Square.\textsuperscript{137} Continental encountered other problems and had to be nationalized by the federal government,\textsuperscript{138} which supplied several billion dollars to prop up the bank.\textsuperscript{139}

In 1980, BankAmerica Corp was the largest, most profitable bank in the world. Six years later, it posted a loss of more than $1 billion.\textsuperscript{140} Between 1980 and 1985, the Bank of America had to write off over $4 billion in bad loans\textsuperscript{141} and an additional $7 billion in Latin American loans was in doubt.\textsuperscript{142} Over forty banks failed each year during the middle of the 1980s.\textsuperscript{143} The number of “problem” depository institutions on the FDIC watch list rose substantially. In 1984, the FDIC had a list of over 500 problem banks.\textsuperscript{144} That number soon increased to 800.\textsuperscript{145} By 1986, over 1,000 institutions were on the FDIC watch list.\textsuperscript{146}

I. The Thrifts

The thrifts were another group in the banking sector that were being hurt by artificial regulatory restraints on their business and disintermediation. Congress lifted the interest rate ceilings on the amount of interest these institutions could pay for deposits as interest rates rose. When the interest rate ceilings were raised, the thrifts were left with a problem. The loans on their books were paying interest rates lower than what they had to pay for deposits at market

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\textsuperscript{137} See GARY HECTOR, BREAKING THE BANK, THE DECLINE OF BANKAMERICA 163 (1988); WOLFSON, supra note 128, at 87.
\textsuperscript{139} See D’ARISTA 2, supra note 111, at 389.
\textsuperscript{140} See HECTOR, supra note 137, at 1.
\textsuperscript{141} See GREIDER, supra note 102, at 632.
\textsuperscript{142} See HECTOR, supra note 137, at 163. BankAmerica was not the only bank in trouble from Latin American debt. Citicorp had non-performing foreign loans in 1983 in excess of $1.7 billion. See ZWEIG, supra note 107, at 790.
\textsuperscript{143} See FEARON, supra note 97, at 221.
\textsuperscript{144} See id.
\textsuperscript{145} See D’ARISTA 2, supra note 111, at 365.
\textsuperscript{146} See id.
In 1981, after enactment of the Depository Institutions Deregulation and Monetary Control Act of 1980, the thrifts were paying an average of eleven percent for their funds, while their mortgage portfolios were yielding only ten percent. The thrifts lost a total of $8.9 billion in 1981 and 1982. Eighty-one thrifts failed in 1981 and over 250 failed in the following year. By 1984, over thirty percent of all FSLIC insured institutions were operating at a loss.

Congress and the states tried to assist the thrifts by lifting restrictions on their investments. This laid the groundwork for arguably the worst financial disaster in history. The S&Ls in particular went on a binge in investing in shopping centers, malls, and other non-residential real estate. Depositors withdrew their money in order to obtain higher rates from other investments. The thrifts could not raise their rates because of interest rate ceilings. Regulators provided some relief to the thrifts in 1978 by allowing them to sell money market certificates. Nevertheless, short term rates continued to rise, while income from fixed rate mortgages issued at lower rates was inadequate to cover costs. The mismatch between long term loans and short term liabilities resulted in the thrifts paying more to attract funds than they were earning on their mortgage portfolios. See Wolfson, supra note 128, at 66, 80-81; H.R. Rep. No. 101-54, at 1 (1989).

The Depository Institution Deregulation and Monetary Control Act of 1980 authorized depository institutions, including thrifts and credit unions, to offer interest bearing NOW accounts. This legislation sought to phase out interest rate caps on bank and thrift deposits. See D'Arista 2, supra note 111, at 87; H.R. Rep. No. 101-54 (I), 101st Cong., 1st Sess. 1 (1989). The phase out of interest rate ceilings on time and savings deposits that began in 1980 was not completed until 1987. See Federal Reserve Bank of New York, Understanding the M's in Monetary Policy 9 (1994).

See H.R. Rep. No. 101-54, at pt. I (1989). The freeing of interest rates paid on deposits allowed the thrifts to compete for investor funds by paying higher interest rates. Deposit brokers assisted the thrifts in that effort. Large sums obtained from institutional investors by the deposit brokers were broken up into tranches of $100,000 in order for their deposits to be fully insured. See Robert Emmet Long, Banking Scandals: The S&Ls and BCCI 13 (1993). The 1980 Act had increased the amount of insurance from $40,000 to $100,000 per account.

See id. The Federal Home Loan Bank Board began encouraging mergers with S&Ls that were running into financial difficulty. Over 700 such mergers occurred between 1981 and 1982. See Wolfson, supra note 128, 81.

The situation was exacerbated by the fact that a change in accounting standards allowed the S&Ls to adopt accounting methods that masked the magnitude of the problems that the industry was suffering. See H.R. Rep. No. 101-54, pt. I, at 308 (1989).

The Depository Institutions Act of 1982 (the "Garn-St-Germain" act) allowed S&Ls to invest up to 40% of their loans in non-residential real estate, 30% in consumer loans and up to 30% of their assets in equity investments. See Long, supra note 149, at 15; H.R. Rep. No. 101-54, at 297; Wolfson, supra note 128, at 100.
buildings and other projects, particularly in the southwest, after investment restrictions were eased. The "go-go" thrifts of this era invested in a number of speculative enterprises that included oil and drill operations and such things as windmill farms. S&Ls became a favorite dumping ground for junk bonds, many of which were purchased from Drexel Burnham Lambert and Michael Milken. The S&Ls owned about seven percent of outstanding junk bonds at one point. Those holdings were concentrated into a few large S&Ls. Total thrift liabilities grew from $674 billion to $1.1 trillion dollars.

The financial difficulties of the S&Ls raised concerns that the Federal Savings and Loan Insurance Corporation ("FSLIC") would not have sufficient funds to pay insured deposits. In March of 1982, Congress passed a joint resolution supporting FSLIC. The resolution stated that the full faith and credit of the United States would stand behind FSLIC and the FDIC. This set the federal government up for a financial disaster of unbelievable dimensions. When real estate values collapsed at the end of the 1980s, all of the problems that had been building in the S&Ls were exposed and hundreds of S&Ls failed. A majority of the distressed thrift associations were in California and Texas. In 1987, the S&L industry lost some $7 billion. In 1988, over 700 banks and over 1,000 S&Ls were being closed down. Costs to taxpayers from the failed S&Ls were predicted to range from $500 billion to $1 trillion. One congressional subcommittee called the S&L crisis "the greatest financial fiasco the United States has ever seen." Regulators estimated that forty percent of the thrift failures were due to fraud or insider

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154. See Long, supra note 149, at 36.
155. See Wolfson, supra note 128, at 101.
158. See Wolfson, supra note 128, at 81.
160. See Hector, supra note 137, at 347.
162. See D'Arista 2, supra note 111, at 413.
163. See Long, supra note 149, at 7.
abuse. By 1992, some 1,000 individuals had been charged with crimes in connection with S&L activities.

The Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA") set aside federal funds to protect the customers of S&Ls that had failed. This legislation reorganized the regulation and insurance system for S&Ls. FSLIC was replaced by the Savings Association Insurance Fund, and the FDIC was put in charge of administering that fund. The legislation appropriated an initial allocation of $50 billion to close down insolvent thrifts and pay off depositors. The legislation also abolished the Federal Home Loan Bank Board and replaced it with the newly formed Office of Thrift Supervision, which was a bureau of the Treasury Department.

The Resolution Trust Corporation ("RTC") was established in 1989 to take over failed S&Ls, pay off their depositors and then sell their assets. The RTC quickly became one of the largest managers of financial and real estate properties in the United States. The final cost to American taxpayers for the S&L crisis proved to be much less than originally estimated, but still totaled at least $90 billion. This entire debacle was strong evidence that the regulatory structure in the United States was not constructed on the basis of

166. See id. at 28. The government even brought an enforcement action against Kaye, Scholer, Fierman, Hayes & Handler, a large New York law firm, for representing Charles Keating's Lincoln Savings & Loan that was engaged in a broad range of questionable activities. See Macey & Miller, supra note 136, at 341-343; Howell E. Jackson, Reflections of Kay, Scholer: Enlisting Lawyers to Improve the Regulation of Financial Institutions, 66 S. Cal. L. Rev. 1019 (1993).
169. See Wolfsion, supra note 128, at 131.
170. See id.
172. See Long, supra note 149, at 48-49.
173. See Japan's Financial Crisis, The Economist, Dec. 6, 1997, at 81. A decision by the Supreme Court which held that federal regulators had improperly changed accounting rules for the S&Ls is expected to add many billions to this bill. See Paul Sweeney, How to Win Big in Court and Never See a Lawyer, N. Y. Times, Nov. 1, 1998, at 10 (Business Section).
scientific principles. A prime culprit appeared to be the artificial regulatory restrictions on S&Ls that led them to try to play catch-up through speculative investments. The fact that they were dealing with insured funds relieved the depositors of any responsibility for monitoring the S&Ls investments. It was free money, and the unscrupulous were quick to take advantage.174

J. Banking Changes

In the early 1990s, the only states that allowed interstate branches were Alaska, Nevada, New York, North Carolina, Oregon and Rhode Island.175 By the middle of the 1990s, every state was permitting multi-office banking.176 Yet, “no commercial banking organization was even close to establishing a truly nationwide franchise.”177 That situation would quickly change. Interstate banking on a regional basis had begun in the 1980s,178 and the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 finally opened the door widely to interstate banking.179 That legislation al-

174. Loan brokers divided large deposits into amounts of $100,000, the maximum amount covered by federal insurance. Those deposits were then placed with several banks. This allowed investors to avoid credit risk concerns, and the brokers would shop for the highest CD rates. The bank regulators sought to stop this practice, viewing it as an abuse of federal insurance. The Court of Appeals for the District of Columbia, however, ruled that the FDIC and FSLIC could not adopt a rule that limited insurance coverage to $100,000 per money broker per institution where funds were being placed by a broker. See FAIC Sec. Co., Inc. v. United States, 768 F.2d 352, 361 (D.C. Cir. 1985). Later, in 1989, limits were placed by Congress on the amount of brokered deposits that an institution could accept. See CAPATIDES, supra note 130, at 54.


176. See MACBY & MILLER, supra note 136, at 407.

177. See JOHN SPiegel, ALLEN GART & STEVEN GART, BANKING REDEFINED, How SUPERREGIONAL POWERHOUSES ARE RESHAPING FINANCIAL SERVICES 472 (1999).


179. See ZHOU, supra note 178, at 18.
allowed bank holding companies to acquire banks in any state, and after July 1, 1997, merge multiple banks together, retaining the interstate as branches of the main bank. 180

Banks also began to introduce ATMs (automated teller machines) as a way of expanding their reach. When the Comptroller of the Currency ruled that those machines were not branches, 181 ATMs spread across America. 182 By 1996, there were some 120,000 ATMs in the United States that were dispensing $9 billion in cash a year. 183

Grocery stores even became a favorite location for banking cen-

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180. Banks were allowed to open interstate branches without having to create a separate banking corporation in each state. See Introduction, 1 N.C. Banking Inst. xiii, xvii (1997); Brady & Purpura, supra note 175, at 230. States could opt in or out of this legislation. Forty-eight states opted into the Riegle-Neal interstate branching provisions. See ZHOU, supra note 178, at 18; HALS. SCOTT & PHILIP A. WELLONS, INTERNATIONAL FINANCE 132-133 (1996); Brady & Purpura, supra note 175, at 225. Only Texas and Montana did not accede to these provisions. See Kyle Marshall, Banks in Stores Catching on Fast, NEWS & OBSERVER (Raleigh), Jan. 4, 1997 at D1. Later, the Riegle-Neal Amendments Act of 1997 gave host states control over interstate branches within their jurisdiction to the same extent that the host state's laws would control the interstate branches of national banks. See Brady & Purpura, supra note 175, at 230-231.

181. Some courts had held that ATMs were branches, which would have sharply restricted their use. See Independent Bankers Association of America v. Smith, 534 F.2d 921, 951 (D.C. Cir.), cert. denied, 429 U.S. 862 (1976). The Comptroller of the Currency eased that problem by ruling shared ATMs were not "established and operated" by a national bank and thus were not subject to the McFadden Act's branch limitations. These were ATMs that were owned by an independent organization that shared the ATM with the banks. See Donald C. Langevoort, Interpreting the McFadden Act: The Politics and Economics of Shared ATMs and Discount Brokerage Houses, 41 Bus. Law. 1265, 1273-1274 (1986). Many states reacted by decreeing that ATMs were not branches under state law, permitting state chartered banks to establish ATMs across state lines.

182. About 50,000 ATMs were in operation in the United States by 1983. That amount nearly doubled by 1990. See Bruce Zagaris and Scott D. MacDonald, Money Laundering, Financial Fraud, and Technology: The Perils of an Instantaneous Economy, 26 GEO. WASH. J. INT'L L. & Econ. 1, 71 (1992). ATMs raised some new legal problems. ATM access cards were lost and stolen in large numbers, and the courts were asked to sort out issues of liability between the bank and the depositors when ATM cards were used improperly. See D'ARISTA 2, supra note 111, at 148, n.38. Robberies at ATMs were raised additional security concerns. New York City eventually adopted an ATM security law, but crimes connected with the ATMs still increased. See Jim King, Business Report: On Banking, ATLANTA CONSTITUTION, Dec. 10, 1993, at G2.

Technology was making other inroads. S&Ls and banks were allowed to make pre-authorized transfers from savings accounts for household payments in 1970. In 1975, telephone transfers were allowed for savings balances at commercial banks. Banks and thrifts were using automatic transfer services for savings balances in 1978. Credit unions were using share drafts for withdrawals. See FEDERAL RESERVE BANK OF NEW YORK, UNDERSTANDING THE M'S IN MONETARY POLICY (1994).

183. See MAYER, supra note 178, at 141.
The 1980s witnessed a change from “relationship” banking to “transactional” banking. Previously, banks had depended on established relationships with customers as the basis for their lending business. The banks were constantly trying to expand their relationships by acquiring new customers. That approach was being abandoned. Instead, banks began selling by product line to customers with whom they did not always have a relationship. Banks had several products to offer, including cash management services and computerized programs that allowed corporations to readily access their cash positions and bank accounts, as well as to transfer balances and funds.

The securitization of assets transformed banks from deposit takers and loan makers into conduits for loans as underwriters and distributors. Mezzanine finance became an important market for banks. This is debt located between senior debt and common equity in corporate capital structures. Banks were engaging in loan par-

185. See WILSON, supra note 38, at 284.
186. GNMA popularized the pass through mortgage security in which mortgage loans were pooled and interests in the pool sold to investors. This asset backed debt instrument provided additional funding for new mortgages when interests in the pool were sold. Asset-backed debt spread to private mortgage transactions. The originators of these programs were often banks that packaged their mortgages in a pool and sold bonds that were secured by those mortgages. See Alan Kronovet, Note, An Overview of Commercial Mortgage Backed Securitization: The Devil is In the Details, 1 N. C. BANKING INST. 288, 293-294 (1997). Banks and other financial institutions soon found themselves originating mortgages, placing them in a pool, selling participations in the pool to investors and then using the proceeds to generate further mortgages. See ZWEIG, supra note 107, at 805. In the process, those banks were acting more like conduits than the traditional mortgage granting financial institutions of the past. See generally, S. Rep. No. 293, 98th Cong., 1st Sess. 2 (1983); KENNETH G. LORE, MORTGAGE-BACKED SECURITIES, DEVELOPMENTS AND TRENDS IN THE SECONDARY MORTGAGE MARKET (1994). The securitization concept later expanded to include credit card balances and other cash flows. Over $150 billion of non-mortgage asset-backed securities were issued in 1991 for such things as automobile loans, credit card receivables, computer and airplane leases, mobile homes, vacation time shares, and recreational vehicle loans. See SEC DIVISION OF INVESTMENT MANAGEMENT, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 11-13 (1992).
187. Such debt included subordinated debt, junior subordinated debt or even preferred stock. Warrants were attached to some of these loans to provide an upside to banks. See John R. Willis & David A. Clark, Introduction to Mezzanine Finance and Private Equity, in NEW DEVELOPMENTS IN COMMERCIAL BANKING 323 (Donald Chew ed., 1991).
ticipations in which loans were originated and sold off to a group of banks to spread the risk. 88 Syndicated lending reached a value of $1 trillion in 1997. 89 Banks continued to account for a significant portion of the underwriting of state and municipal bonds. 90 Home equity lines became popular in the 1980s. 91 Driven by floating exchange rates, foreign exchange trading in the inter-bank currency market was totaling about $60 billion a day in New York in 1986. That figure would increase to over $100 billion in 1989. Worldwide, average daily foreign exchange trading at that time was $1 trillion. 92 The banks appeared to be less and less like banks and more and more like financial services firms.

The banks increased their role in providing financial services. This included “selling stocks and bonds, providing advice on mergers and acquisitions, concocting new fangled financial products and trading.” 93 Banks were offering instruments that had elements of securities and commodity futures and options. One such product was indexed certificates of deposit. These included the bulls/bears CDs that were issued by Chase Manhattan Bank. The return on this certificate was based on fluctuations in the Standard & Poor’s 500 stock market index. The College Savings Bank of Princeton, New Jersey offered tuition-linked certificates of deposit. The depositor’s return from these CDs was based on an increase in an index of tuition, room and board for 500 colleges and universities. 94 Franklin Savings and Loan Association in Kansas began offering certificates of deposit that provided a rate of return of three percentage points above the rate of inflation. 95

188. See id. at 111.
190. See D’ARISTA 2, supra note 111, at 237.
191. See id. at 273.
192. See CAPATIDES, supra note 130, at 194.
194. See CAPATIDES, supra note 130, at 44.
195. See id. Gold-linked certificates of deposit were being offered by the Wells Fargo Bank. These certificates gave the customer the option of receiving interest at a set rate or a return that was based on increases in the price of gold. The CFTC, however, sued Wells Fargo, contending that these were illegal commodity options. Wells Fargo agreed to an injunction against further offerings of these instruments. See Jerry
Banks were becoming more involved in commodity futures markets activities. The banking regulators were of the view that futures trading activities were closely related to banking and permissible under the Bank Holding Company Act of 1956. In 1982, the Fed approved the application of J.P. Morgan & Co., Inc. to establish a futures commission merchant affiliate that would be regulated by the CFTC. It was to deal in futures contracts involving bullion and foreign exchange, United States government securities, money market instruments and Eurodollar certificates of deposit. About the same time, the Fed authorized Bankers Trust to establish a futures commission merchant (B.T. Markets Corp.) that would trade for customers in futures contracts on United States government securities, money market interest rates, foreign exchange and bullion.


196. See CAPATIDES, supra note 130, at 185-186. Banks had traditionally used the commodity futures markets in their crop financing programs. Those programs often required the commodities being financed to be hedged by futures contracts. See Jerry W. Markham & David J. Gilberg, Federal Regulation of Bank Activities in the Commodity Markets 39 Bus. Law. 1719, 1766-1767 (1984).

197. See Markham & Gilberg, supra note 196, at 1743.

198. See id.

199. See id. at 1747. Banks would become involved in the marketing of so-called over-the-counter derivatives or hybrid instruments. These included gold and silver bullion transactions on a twenty-four hour basis on the London and other futures markets. See id. at 1769.
K. The Glass-Steagall Act

The banks were intruding into the securities business. The securities industry was able to slow this process by court challenges. For example, in \textit{Securities Industry Association v. Board of Governors of the Federal Reserve System},\textsuperscript{200} the Supreme Court held that Bankers Trust Co. could not market commercial paper for its corporate customers.\textsuperscript{201} The Court held in \textit{Investment Company Institute v. Camp},\textsuperscript{202} that commercial banks could not offer commingled investment accounts because of the provisions of the Glass-Steagall Act.\textsuperscript{203} Nevertheless, the reintegration of the banks back into the securities business was inexorable, especially since it appeared that their very survival was dependent on it. The bank regulators recognized this fact and continued to open the door wider for the banks to expand their securities activities.

The banks then began to exploit the provisions of section 20 of the Glass-Steagall Act, which prohibited bank securities affiliates from being "principally engaged" in the investment banking aspects on non-exempt securities transactions. In \textit{Securities Industry Association v. Board of Governors of the Federal Reserve System}, the District of Columbia Circuit Court of Appeals held that the Fed could properly allow bank affiliates to engage in up to five percent of ineligible securities activities without running afoul of the Glass-Steagall prohibition that bank affiliates not be "principally engaged" in such activities.

\textsuperscript{202} 401 U.S. 617 (1971).
\textsuperscript{203} \textit{See id.} In \textit{Arnold Tours, Inc. v. Camp}, 472 F.2d 427 (1st Cir. 1972), the Court held that it was illegal for a national bank to operate a travel agency because such activities were not incidental to the powers of a bank under the National Bank Act. The District of Columbia Circuit Court of Appeals held that the Federal Reserve had gone too far in finding that courier services were incidental to banking for non-financially related courier services. \textit{See National Courier Ass'n v. Board of Governors of the Fed. Reserve Sys.}, 516 F.2d 1229 (D.C. Cir. 1975). In another case, a federal court held that banks could not provide data processing services to merchants unless it was limited to banking activities. \textit{National Retailers Corp. of Arizona v. Valley Nat'l Bank}, 411 F. Supp. 308 (D.Ariz. 1976), \textit{aff'd}, 604 F.2d 32 (9th Cir. 1979).
activity. The Comptroller of the Currency authorized the Security Pacific National Bank to create a subsidiary called Discount Brokerage Service in August of 1982. Thereafter, more than 200 banks created joint ventures with discount brokers. The Fed also concluded that discount brokerage services were closely related to bank activities and, therefore, permissible under the Bank Holding Company Act. In 1983, the Fed approved the acquisition by BankAmerica Corporation of Charles Schwab, the nation's largest discount broker. That action was upheld by the Supreme Court in Securities Industry Association v. Board of Governors of the Federal Reserve System. Numerous banks entered the discount brokerage business following this ruling.

Although they were still hobbled by banking restrictions that limited their ability to cross-sell non-traditional commercial bank services, the banks continued to seek to offer financial services. In Board of Governors v. Investment Company Institute, the Supreme Court held that the Fed could permit bank holding companies to act as investment advisors to closed-end investment companies. The Comptroller of the Currency later allowed banks to manage IRA funds in a common trust fund. This was upheld by a Court of Appeals.

The SEC was not unmindful of these intrusions into the securities business. The SEC adopted a rule in 1985 that would have required banks to register with it, if the banks were engaged in the securities business. The Court of Appeals for the District of Colum-

204. Securities Industry Association v. Board of Governors of the Federal Reserve System, 839 F.2d 47 (2d Cir.), cert. denied, 486 U.S. 1059 (1988). The Fed ruling permitted bank affiliates to engage in up to 5% of ineligible securities activities. See MACEY & MILLER, supra note 136, at 547-549. This was increased to 10% in 1989, and to 25% in 1996. See id.
205. See D'ARISTA 2, supra note 111, at 311.
206. See id. at 77.
207. 716 F.2d 92 (1983).
210. See id. See CAPATIDES, supra note 130, at 95-96.
bia held that the rule exceeded the SEC’s authority.\textsuperscript{211} Congress was also becoming concerned with the intrusion of banks into the securities industry. The Competitive Equality Banking Act of 1987\textsuperscript{212} imposed a one-year moratorium on Fed approval of further securities activities by banks. That slowed the banks only briefly.\textsuperscript{213} The Senate passed a bill that would have essentially repealed the Glass-Steagall Act in 1988. This proposed legislation would have allowed the banks to create subsidiaries that could engage in a broad range of securities activities. The House of Representatives did not adopt a similar bill, but this did not discourage bank regulators from continuing to take an expansive view of what activities were appropriate for bank holding companies.\textsuperscript{214}

\textbf{L. Bank Restructuring Continues}

Even with an expanded business base, the number of banks had declined from around 14,000 in 1980 to under 10,000 in 1995. This statistic reflected the fact that a “massive restructuring” of the

\begin{itemize}
\item \textsuperscript{211} See American Bankers Ass’n v Securities and Exch. Comm’n, 804 F.2d 739 (D. C. Cir. 1986).
\item \textsuperscript{212} Pub. L. No. 100-86, 101 Stat. 552.
\item \textsuperscript{213} Among the things that the Federal Reserve Board has concluded to be closely related to banking by the 1990s were trust company functions, acting as an investment or financial advisor to real estate or mortgage trusts or to investment companies, leasing personal or real property, acting as underwriter for credit life insurance and credit accident and health insurance directly related to an extension of credit, providing courier service for checks and commercial papers and documents exchanged among banks and financial institutions, providing management consulting advice to non-affiliated banks and non-bank depository institutions, issuing money orders under $1,000 and selling travelers checks and savings bonds, performing appraisals of real estate, arranging commercial real estate equity financing by acting as an intermediary, providing security and brokerage services, individual retirement accounts and cash management services, underwriting and dealing in obligations of the United States and other government bodies, providing foreign exchange and advisory transactional services including swaps through separate subsidiaries, acting through a separate subsidiary as a futures commission merchant in executing and clearing transactions on commodity exchanges for futures contracts for bullion, foreign exchange, government securities and money market instruments, providing investment advice on financial futures and options on futures, providing tax planning and preparation services, offering check guaranty services, operating an agency for collecting overdue accounts receivable, and operating a credit bureau. See 12 C.F.R. § 225.28 (1999). See also MACEY & MILLER, supra note 136, at 355-356 (discussing Reg Y).
\item \textsuperscript{214} See CAPATIDES, supra note 130, at 1-2.
\end{itemize}
banking industry was occurring through mergers and acquisitions.\(^{215}\) A new form of bank was emerging in the early 1990s. These were super-regional banks. They included Banc One Corporation, First Chicago/NBD Corporation, Fleet Financial, Norwest Corporation, CoreStates, First Union, Wachovia Corporation, Wells Fargo and NationsBank.\(^{216}\) These enterprises became even more aggressive in seeking to expand their business base.

A number of states had for years allowed state chartered banks to provide insurance services to their customers.\(^{217}\) Several states authorized mutual savings banks to engage in the insurance business. South Dakota allowed state chartered banks to engage in a full range of insurance activities.\(^{218}\) National banks had been sharply restricted in their insurance activities\(^{219}\) until the Comptroller ruled in 1990 that sales of credit insurance, disability insurance and title insurance were incidental to the business of banking.\(^{220}\) The Comptroller found other insurance and annuity activities to be incidental to the banking powers of national banks. This included credit life insurance, which seeks to insure a loan against the event of a death or disability of the borrower.\(^{221}\) National banks also exploited a loophole in the National Bank Act that authorized national banks to sell insurance as agents from communities with a population under 5,000.\(^{222}\)

\(^{215}\) See SPIEGEL, GART & GART, supra note 177, at xiii.

\(^{216}\) See generally SPIEGEL, GART & GART, supra note 177.

\(^{217}\) See MACEY & MILLER, supra note 136, at 384.

\(^{218}\) See D'ARISTA 2, supra note 111, at 78.


\(^{222}\) See 12 U.S.C. § 92; Rabemacher, supra note 220, at 754-755. The Comptroller allowed banks to operate insurance agencies out of those small communities even where their main office was located in a large city. See Williams, supra note 221, at 17.
The national banks were given a boost in their efforts to intrude into the insurance industry in 1995 after the Supreme Court held in *NationsBank v. Variable Annuity Life Insurance Company*,\(^{223}\) that a national bank could sell fixed and variable rate annuities. The Court further held that annuities were investments rather than insurance.\(^{224}\) The Fed began permitting bank holding companies to sell insurance.\(^{225}\) The Garn-St Germain Act of 1982, however, prohibited the Fed from considering underwriting of insurance as an activity that is "closely related to banking."\(^{226}\) In December of 1996, the Comptroller of the Currency adopted amendments to its regulations that allowed even further intrusion by bank subsidiaries into the insurance business.\(^{227}\) The Supreme Court held in *Barnett Bank of Marion County, N.A. v. Nelson*,\(^{228}\) that state legislation could not restrict national banks from selling insurance. By 1996, most banks were selling some form of life insurance product.\(^{229}\) In 1997, banks were then selling twenty-five to thirty percent of the insurance industry's annuities.\(^{230}\)

The banks could no longer depend on the deposit business as their prime basis for generating revenues. This was underscored by the fact that, by 1993, commercial bank deposits were exceeded in amount by the funds held by mutual funds.\(^{231}\) The banks responded to that threat by creating their own mutual funds, and continued their efforts of aggressively pursuing other securities related busi-

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A court held that national bank offices in towns of less than 5,000 could be used to sell insurance to customers nationwide. See Independent Ins. Agents of America, Inc. v Ludwig, 997 F.2d 968 (D.C. Cir. 1992); Julie L. Williams, *et al.*, *After Barnett: The Intersection of National Bank Insurance Powers and State Regulations*, 1 N. C. BANKING INST. 13, 15-16 (1997).

224. See generally Rabemacher, supra note 220, at 761.
225. See Zweig, supra note 107, at 809.
230. See Kirsch, supra note 220, at 85.
ness. In 1993, a third of all mutual funds were being sold through banks. Banks were offering "private label" mutual funds as well as those of other organizations.

As the century aged, the banks continued to drop their traditional lending business and increase their role in financial services such as selling securities, engaging in repos, providing advice on mergers and creating and selling derivative instruments such as swaps. By the middle of the 1990s, many of the larger banks were receiving from one-third to over fifty percent of their revenues from non-interest income. By 1994, banks were involved in selling United States Treasury securities, lease and other asset backed securities, municipal securities, corporate bonds, corporate equities, financial and precious metal futures, as well as bullion. They were


233. See Penny Lunt, How Are Mutual Funds Changing Banks?, A.B.A. BANKING J., June 1, 1993, available in 1993 WL 3004317. In 1993, Concord Holding Corp., which had been created in 1987, was administering and distributing mutual funds for banks. At that time, it was handling over $36 billion in assets. There were some 16 similar firms that were operating mutual funds for banks in order to avoid Glass-Steagall prohibitions on banks underwriting activities. See Alyssa A. Lappen, Fund Follies, INSTITUTIONAL INVESTOR, Oct. 1, 1993, available in 1993 WL 12229261. Mellon Bank acquired Dreyfus and became the largest bank manager of mutual funds. It was also the second largest asset manager in the United States. See SPIEGEL, GART & GART, supra note 177, at 300. For descriptions of other bank mutual fund arrangements, see Marcia Parker, Crains New York Business, 1993 WL 2989529 (Apr. 19, 1993); Stan Hinden, Banks Picking Mutual Funds Face Questions on Disclosure of Risks, WASHINGTON POST, Mar. 24, 1993, at F3.

First Union bought Lieber & Co. in 1993. It was the manager of $2.2 billion dollars of Evergreen Mutual Funds. See Jane Bennett, Banks Using Mutual Funds to Keep Customers, THE JACKSONVILLE BUSINESS JOURNAL, Dec. 31, 1993, available in 1993 WL 3026956. First Union announced in 1996 that it was seeking to have $100 billion in mutual fund asset sales by the year 2000. See Introduction, 1 N.C. Banking Inst. xiii, xix (1997). First Union had earlier announced that it was training 2,600 employees to sell mutual funds including 12 of its own funds by the end of 1994. In the following year, NationsBank added 11 mutual funds to its 28 mutual funds that were already under its management. See Rick Brooks, Banks Rush to Offer Blitz of Mutual Funds, CHARLOTTE BUSINESS JOURNAL, July 12, 1993, available in 1993 WL 2988430. Citibank was selling a family of mutual funds, after regulatory changes allowed the banks to use their names in selling such securities. See Julie Creswell, Citibank Fund Group to Get a Change of Name, But Will It Help Returns?, WALL ST. J., Feb. 17, 1998, at 8B.

234. See ZWIEG, supra note 107, at 807.


236. See SPIEGEL, GART & GART, supra note 177, at 40.
acting in private placements as agents, were sponsoring closed end investment funds and were offering deposit accounts with returns that were tied to stock market performance. Other bank activities included Eurodollar dealings, mergers and acquisitions, trust investments, automatic investment services, dividend investment services, financial advising, discount brokerage activities, securities swaps and research services.237 Chemical Bank reported revenues of $1 billion based on proprietary trading activities in 1993. Bankers Trust made more profits from trading than from its lending activities during the first quarter of 1994,238 in fact some seventy percent of its first quarter profits in 1994 came from derivative products.239 In total, banks accounted for some $12 to $14 trillion dollars of derivatives sold in the United States in 1994.240 Though at one point, over fifty percent of revenue for Bankers Trust was from derivatives transactions; some of those gains would turn sour when Bankers Trust was sued by customers that experienced large losses from those transactions.241 The top dealers in over-the-counter derivatives in 1993 were Chemical Bank, Citicorp, Bankers Trust, Societe Generale, J.P. Morgan, and the Union Bank of Switzerland.242 Citicorp was earning most of its profits in the emerging markets in 1997.243

The barriers between investment banking and commercial banking continued to erode. The Bank Service Corporation Act allowed banks to operate service corporations that could perform back office services for banks and certain other activities.244 The Comptroller adopted regulations in 1996 that permitted national banks to establish “operating subsidiaries” to engage in activities

237. See Kirsch, supra note 220, at 11.
239. See id. at 68-69, n.262.
240. See id. at 48, n.198.
241. See id. at 37, n.155.
242. See Kirsch, supra note 220, at 146.
that national banks could not engage in directly. Although Zions First National Bank was given permission to deal in municipal revenue bonds through its operating subsidiary; such dealings had been traditionally prohibited for national banks under Glass-Steagall as investment banking activities.

The Fed announced in December of 1996 that it was increasing from ten to twenty-five percent the amount of total revenues that a non-bank subsidiary of a bank holding company could derive from underwriting and dealing in securities. This allowed banks to expand their securities activities in their Section 20 affiliates under the Glass-Steagall Act. It was thought that these changes would allow "one stop financial shopping at banks and bank holding companies." This change enabled Bankers Trust to acquire Alexander Brown in 1997 through a share swap transaction valued at $1.7 billion. U.S. Bancorp announced the acquisition of Piper Jaffrey Co. in December of 1997. Piper Jaffrey was then the eleventh largest securities firm in the United States. First Union acquired Wheat First Butcher Singer, a broker-dealer based in Richmond, Virginia. Swiss Bank Corporation announced in May of 1997 that it was acquiring Dillon Read for some $600 million. In July of 1997, NationsBank Corporation purchased Montgomery Securities,


249. See David R. Satin, Breaking Down the Wall, The Unofficial End of Glass-Steagall, BANK SEC. J. at 11, 11 (July/August, 1997).


252. See Beyer, supra note 219, at v.

253. See Tracy Corrigan & George Graham, SBC Wins Place on Wall St, FIN. TIMES, May 16, 1997, at 32.

These changes were dramatically altering the business of banking. The erosion of the barriers between investment banking and commercial banking led one paper to conclude that J.P. Morgan was looking increasingly more like an investment bank.\footnote{See \textit{The Changing World of J P Morgan}, FIN. TIMES, Jan. 2, 1997, at 13.} The new role being played by banks was illustrated by a two page advertisement in the Wall Street Journal in February of 1998 that announced NationsBank's results for the prior year. In that year, the bank handled initial public offerings worth $4.5 billion; high-yield ("junk bond") transactions worth $16.7 billion; mergers and acquisitions worth $14.5 billion; "follow-ons" worth $11.8 billion; syndicated floating rate debt of $442 billion; convertible securities underwritten in the amount of $3.7 billion; private placements worth $940 million; real estate finance valued at $30.2 billion; high-grade securities underwritings of $30.6 billion; asset-backed securities underwritings at $22.5 billion and project finance of $5.7 billion.\footnote{See \textit{1997 Results - $559 Billion in Transactions}, WALLST. J., Feb. 11, 1998, at A12 (advertisement by NationsBank).}

\section*{M. Glass-Steagall Falls At Last}

Four record-setting banking acquisitions occurred in the first half of 1995. They were Fleet Financial and Shawmet National; First Union and First Fidelity; First Chicago and NBD; and Chemical Bank and Chase Manhattan.\footnote{See SPIEGEL, \textit{GART & GART}, \textit{supra} note 177, at 64.} In another merger, Security Pacific joined BankAmerica.\footnote{See Floyd Norris, \textit{As More Banks Vanish, Wall St. Cheers}, N.Y. TIMES, Aug. 29, 1995, at D1.} In 1996, NationsBank went on a binge of acquisitions that included Boatmen's Bancshares, Inc. in St. Louis

In March of 1998, Washington Mutual bought H. F. Ahmanson for $10 billion. With that merger, Washington Mutual would have assets of $150 billion. Norwest, a Minneapolis bank, announced in June of 1998 that it was acquiring Wells Fargo in a stock swap that was valued at $31.2 billion. The merger of Bank One and First Chicago made BankOne the largest bank in the Midwest, and one of the larger issuer of credit cards in the United States. National City agreed to buy the First of America Bank for over $6 billion in stock in 1997. In April of 1998, Citicorp announced a planned merger with Travelers Group, Inc. which owned Salomon Brothers and Smith Barney. The value of this merger was set at $83 billion. Before its merger with Travelers Group, Citicorp had relationships with one in five households in the United States. The combined entity had more than 100 million customers worldwide, and it offered a wide range of products that varied from cor-

261. See Joel B. Obermayer, First Union Buys Pa. Bank, NEWS & OBSERVER (Raleigh), Nov. 19, 1997, at 1A.
263. See id.
264. See Business This Week, THE ECONOMIST, Mar. 21, 1998, at 5.
porate finance to consumer banking and securities.\textsuperscript{271} The Citigroup amalgamation was matched by the merger of BankAmerica and NationsBank.\textsuperscript{272} In 1998 a consolidation of banking and financial services was also occurring in Europe as well as in the United States.\textsuperscript{273} The Deutsche Bank announced on November 23, 1998 that it was acquiring Bankers Trust for almost $10 billion.\textsuperscript{274} This merger created the world's largest financial services company.\textsuperscript{275}

Agreement was finally reached in October of 1999 on the passage of legislation to repeal the Glass-Steagall Act.\textsuperscript{276} It was expected that this would result in a further consolidation of financial services.\textsuperscript{277} The legislation authorized the creation of financial holding companies that could engage in a broad array of financial services including commercial and investment banking, securities and insurance. Restrictions were eased on the grand-fathered non-bank banks, and operating subsidiaries of national banks were given similarly expanded powers. Unfortunately, the legislation continued efforts by Congress to control the delivery of financial services. Even the new financial holding companies were restricted in their ability to engage in non-financial services. The statute also imposed restrictions on commercial firms that were seeking to enter the banking business by buying or chartering thrifts, by eliminating the

\begin{itemize}
\item \textsuperscript{271} Citigroup later purchased Schroders, PLC in England for $2.2 billion in January of 2000. This acquisition was designed to boost Citigroup's investment banking activities in Europe. \textit{See} Paul Beckett & Erik Portanger, \textit{Citigroup in Deal with U.K.'s Schroders to Boost European Investment Banking}, \textit{Wall St. J.}, Jan. 19, 2000, at C1.
\item \textsuperscript{277} \textit{See} Michael Schroeder, \textit{Glass-Steagall Compromise is Reached}, \textit{Wall St. J.}, Oct. 25, 1999, at A2.
\end{itemize}
unitary thrift holding company loophole that permitted companies owning only a single thrift to engage in any other business without limitation under the Savings and Loan Holding Company Act. This was directed at stopping Wal-Mart from buying or chartering a thrift or from operating Wal-Mart brand banking operations in its stores. Congress additionally continued its effort to force the commercial banks to invest more funds into economically deprived areas through the Community Reinvestment Act ("CRA"). Bank competitors were not subject to similar requirements.

The Gramm-Leach-Bliley Act, which repealed Glass-Steagall’s prohibitions on bank securities activities, maintained the historical “functional” regulatory system as the basis for regulating the expanded activities of the banks and their holding company structures. This meant that traditional commercial banking activities would continue to be regulated by the bank regulators, securities activities would be regulated by the SEC and state securities commissions, commodity futures and options activities would be regulated by the CFTC and insurance activities would be regulated by multiple state insurance regulators.

278. See id.
N. Cyber-Finance Appears

The repeal of the Glass-Steagall Act's restrictions on bank securities activities was a belated recognition of the fact that financial services were no longer being sold in "functional" units, even though that was way they would be continued to be regulated. Banks were changing. They were no longer simply a place to deposit cash and to borrow money. In fact, cash was becoming an anachronism. Coin and paper money accounted for only eight percent of the worldwide supply of American dollars as the century closed. Checks were still popular, but electronic money was replacing such traditional currency in many transactions. The amount of funds being transferred electronically by wire transfers each day was estimated to be in the trillions of dollars. By 1993, electronic transfers totaled $400 trillion in the United States. Over 140 domestic and foreign banks were using CHIPS in 1995. SWIFT was being used by 5,200 financial institutions in 137 countries. A bank Internet payment system project was underway in 1997. It sought to provide secure inter-bank payments through the Internet.

Credit cards were another form of electronic payment that was increasing in popularity. The credit card was becoming a substantial substitute for cash in retail transactions. In October of 1998, Americans owned an average of three credit cards and used them for about twenty-five percent of their spending. Visa and MasterCard were responsible for seventy-five percent of all credit

282. See Weatherford, supra note 279, at 222-223.
283. See Mayer, supra note 179, at 82.
285. See id. at 195.
286. Almost 200 million people were using digital cash in the form of Visa cards around the world by 1990. See Zagaris & MacDonald, supra note 281, at 69.
card purchases in the United States, which totaled more than $600 billion. Their cards were accepted by more than 3.4 million stores. Almost 600 million Visa cards were outstanding by 1997, and they were being accepted at more than fourteen million locations. Those cards were used to purchase over $1 trillion dollars in goods and services. The credit card lending activities of United States banks were their most profitable business. Debit cards were gaining popularity in the United States. These cards acted essentially as electronic checks in that the funds were withdrawn from the customer's account upon use of the card. It has been predicted that by the year 2005 debit card payments will account for forty-eight percent of total credit card transactions, as compared to twenty-one percent in 1997. Experiments

288. See Paul Beckett, Visa, MasterCard Battle with Retailers, WALL ST. J., Nov. 24, 1998, at B12. Visa USA and MasterCard International were the targets of an antitrust suit in October of 1998. The Justice Department was claiming that the joint ownership of Visa and MasterCard by the same group of major banks violated the antitrust laws. The government also claimed that the defendants were preventing banks from issuing American Express cards. See Brian Gruley & Paul Beckett, Visa, MasterCard Named in Antitrust Suit, WALL ST. J., Oct. 8, 1998, at A3. Later, in 1999, Citigroup announced that it was removing itself from the Visa board. Citigroup was annoyed at the fact that Visa was giving itself top billing on the card, while the banks were being given little space for their own logos. It was thought that the larger banks would form their own credit card franchises while the smaller banks would continue to seek the support of the Visa card name for their cards. See John Authers, MasterCard in Boardroom Revamp, FIN. TIMES, Mar. 11, 1999, at 15.


290. See id.


The "merchant processing" business was an important adjunct to the credit card industry. This business involved the obtaining of authorizations for purchases with credit cards at the time of the purchase, processing credit card transactions and settlement of those transactions and depositing funds in merchants' accounts. Many banks engaged in those activities but the principal processors in the middle of the 1990s were NaBANCO/First Data Systems/Card, American Express, Discover, GE Capital, Sears, Establishment Services, First USA and National Data Corporation. See John L. Douglas, Banking Organizations: Structural and Other Considerations Involving Non-Banking Activities, 1 N.C. BANKING INST. 59, 99-100 (1997).

292. See Way to Pay, THE ECONOMIST, Oct. 4, 1997, at 80. The classic credit card allows customer debit balances to build. Those balances may be paid off at the end of the month or carried forward on the basis of a loan from the credit card issuer to the consumer. Interest rates are charged to carry those balances.

293. See Paul Beckett, Visa, MasterCard Battle with Retailers, WALL ST. J., Nov. 24,
with "stored value cards" were being carried out as a substitute for money. These "smart" cards were a variation of the traveler's check. They operated through a micro chip embedded in the card.\textsuperscript{294} Smart cards could be recharged at cash machines or payment could be made from an account or in cash to load the card up for use for purchases.\textsuperscript{295} Super smart cards were being developed that allowed holders to check their bank balance, make securities transactions and perform other functions.\textsuperscript{296} Smart cards sought to act as substitutes for money and were sometimes referred to as "e-purses."\textsuperscript{297} More than seventy million smart cards were distributed in 1996. At that time, their use was doubling annually.\textsuperscript{298} By the end of 1998, however, it seemed that the banks were going to have to reconsider smart cards because consumers were not expressing a great deal of enthusiasm for this payment medium.\textsuperscript{299} 

An effort was underway to develop an electronic check that

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\textsuperscript{297} See Chipper, for now, \textit{THE ECONOMIST}, April 26, 1997, at 77.

\textsuperscript{298} See CRONIN, \textit{supra} note 284, at 137.

\textsuperscript{299} See \textit{Keep the Change}, \textit{THE ECONOMIST}, Nov. 21, 1998, at 73. See also, Paul Beckett & Larry M. Greenberg, \textit{Smart Card Still Needs More Answers, Sponsors Concede, As Big Test Nears End}, \textit{WALL ST. J.}, Nov. 4, 1998, at A4. VisaCash was introduced in 1996. This was a chip-based stored value card and was used at the 1996 Summer Olympics in Atlanta, Georgia. Athletes and visitors were given reloadable smart cards, and numerous merchants agreed to recognize those cards. Over 200,000 transactions were conducted on the cards during the Olympics. See Wilson, \textit{supra} note 295, at 671. Even so, the experiment suggested that consumers might be slow in adapting to these cards. See Saul Hansell, \textit{Got a Dime? Citibank and Chase End Test of Electronic Cash}, \textit{N.Y. TIMES}, Nov. 4, 1998, at C1. Another experiment in virtual money was undertaken by Chase Manhattan Bank, Citibank, Visa USA and MasterCard International in 1998. This program issued tens of thousands of smart cards and installed card readers in about 400 stores in Manhattan. These smart cards had computer chips instead of magnetic strips that could be loaded with as much as $500 through an ATM and used as a substitute for cash purchases. The store owners found, however, that customers did not like the cards. Nevertheless, the banks were still optimistic that the cards would eventually be accepted by the public. See Lisa W. Foderaro, \textit{A Test in Cashless Spending Turns Out to be a Hard Sell}, \textit{N.Y. TIMES}, July 27, 1998, at B4. The smart card would, if widely accepted, be a source of large profits for the banks. In addition to service charges, the banks receive the benefit of the float for the funds stored on the card.
could be written through the Internet on a computer screen using a
digital signature.\textsuperscript{300} A Cybercash system allowed a consumer to
transfer funds through the Internet when purchasing goods.\textsuperscript{301}
DigiCash was developed in 1997 as a means to provide electronic
cash for making payments to an Internet merchant.\textsuperscript{302} Another sys-
tem called NetCash transmitted cash through the Internet using an
encryption scheme.\textsuperscript{303} First Union was offering Cybercoin, a pay-
ment service that allowed purchases to be made over the Internet.\textsuperscript{304}

A First Union executive noted a few years ago that the bank-
ing industry was seeking to eliminate the branch delivery system
and replace it with electronic banking.\textsuperscript{305} Banks had begun examin-
ing the concept of home banking as early as 1970.\textsuperscript{306} Initially, this
was carried out through touch tone telephones and proprietary
software that allowed customers to access account balances and
transfer funds.\textsuperscript{307} Web-based banking allowed greater access.\textsuperscript{308}
Customers could transfer funds, obtain checking account balances,
pay bills, write checks, and transfer funds between accounts and
obtain current interest rates.\textsuperscript{309}

The Office of the Comptroller of the Currency approved a
request in 1996 by Apollo Trust Company to provide home banking
services through the Internet.\textsuperscript{310} At that time, three major banks
were allowing customers to apply and receive automobile loans on-
line.\textsuperscript{311} Wachovia Bank in North Carolina announced in 1997 that its

\begin{thebibliography}{9}
\bibitem{300} See Wilson, \textit{supra} note 295, at 671. Other forms of electronic checks were be-
ing developed that acted much like debit cards. See Cronin, \textit{supra} note 284, at 193-194;
\bibitem{301} See John L. Douglas, \textit{Technology and Banking}, 1 N.C. Banking Inst. 37, 47
(1997).
\bibitem{302} See Randall W. Sifers, \textit{Regulating Electronic Money in Small-Value Payment Sys-
\bibitem{303} See id.
\bibitem{304} See Beyer, \textit{supra} note 219, at xxiv.
\bibitem{305} See Spiegel, \textit{Gart & Gart}, \textit{supra} note 177, at 53-54.
\bibitem{306} See Cronin, \textit{supra} note 284, at 28.
\bibitem{307} See \textit{id.} at 29.
\bibitem{308} See Heather C. Alston, Note, \textit{Will That Be Cash, Credit, or E-Money?}, 1 N.C.
\bibitem{309} See Kimbrelley Kegler, Note, \textit{Electronic Banking: Security, Privacy, and CRA
\bibitem{310} See Wilson, \textit{supra} note 295, at 678-679.
\bibitem{311} See \textit{id.} at 678 n. 45.
\end{thebibliography}
customers could purchase stock, obtain checking account balances and obtain stock quotations over the Internet from the bank.\textsuperscript{312} NationsBank was developing automated loan machines that would allow unsecured personal loans of up to $10,000.\textsuperscript{313} Several banks created Internet sites that allowed transactions to be conducted by customers.\textsuperscript{314} By 1998, over 800,000 customers were conducting online checking with 150 banks.\textsuperscript{315} This was an increase of four hundred percent over the prior eight months.\textsuperscript{316}

Internet banks were being established. These "virtual" banks operated only online. They allowed their customers to open accounts and to perform most of their banking activities through the Internet. The first Internet bank was the Security First Network bank and the second was Atlanta Internet Bank.\textsuperscript{317} These banks obtained a charter from the Office of the Comptroller of the Currency and were covered by FDIC insurance.\textsuperscript{318} The BestBank was another "virtual" bank that operated only on the Internet. Unfortunately, it became bankrupt in September of 1998.\textsuperscript{319}

III. HISTORY IS OUTSTRIPPING REGULATION

History demonstrates that regulation of banks has not been based on any grand design. Rather, its foundations are built on a Civil War need for currency and a populist suspicion of concentrated wealth that peaked with the Great Depression. The result of this history was the creation of multiple state and federal regulators and the division of commercial and investment banking activities into separately regulated institutions. This New Deal regulatory scheme viewed commercial banking to be a single product that

\begin{itemize}
\item \textsuperscript{312} See Beyer, supra note 219, at xxiii (1998).
\item \textsuperscript{313} See id.
\item \textsuperscript{314} See id. See also, CRONIN, supra note 284, at 75.
\item \textsuperscript{315} See CRONIN, supra note 284, at 33.
\item \textsuperscript{316} See id. See generally Christian N. Watson, Note, The Growth of Internet-only Banks: Brick and Mortar Branches are Feeling the "Byte", 4 N.C. BANKING INST. 345 (2000). Most major banks now provide online access to accounts for customers.
\item \textsuperscript{317} See Wilson, supra note 295, at 677; CRONIN, supra note 284, at 75 .
\item \textsuperscript{318} See Wilson, supra note 295, at 676.
\item \textsuperscript{319} See William B. Cahill, Regulators Discover There is No There At a "Virtual" Bank, WALL-ST. J., Sep. 1, 1998, at A1.
\end{itemize}
could be restricted to isolated institutions and intensively regulated "functionally." Congress thought that deposit insurance would maintain public confidence and prevent runs on banks in times of stress. The exposure to that deposit insurance liability, however, required the government to regulate every aspect of banking operations to assure that undue risks were not being incurred. At the same time, the government removed market discipline by allowing bank creditors (viz. depositors) to abrogate their traditional monitoring function. This approach worked as long as interest rates and economic conditions were stable and competition for bank services could be curbed. The inflation of the 1960s and the creation of the money market funds undermined all of those assumptions. The bank and thrift regulators then tried to allow deposit institutions to become market participants by lifting investment restrictions. The regulators overlooked the dangers that deposit insurance posed once those barriers were removed. The staid 3-6-3 bankers were replaced by gangs of "go-go" buccaneers who were only too happy to gamble for their own benefit with other people's money, particularly when there was no one to monitor their activities.

Put gently, functional regulation has historically been less than a success. More importantly, modern banking no longer fits the 1930s profile around which financial services regulation is built. Banks are acting as conduits by generating loans that are securitized or syndicated and then sold rather than retained as assets in the manner of traditional commercial banking. The deposit business of commercial banks is shrinking and is in competition with the money market mutual funds. Branching restrictions have been removed, and banks are concentrating and expanding their product lines. The effects of these changes were aptly summarized in a 1995 Treasury Department document, which noted that:

- The share of total private financial assets held by insured depository institutions has declined sharply, from about 60 percent in 1970 to less than 35 percent today.

Only 15 percent of all financial assets held by households and the non-profit sector in 1994 was accounted for by insured deposits.

Recent data show that, of the 20 largest financial firms in the United States, only 5 are commercial banks. Moreover, a number of diversified financial services firms own non-bank, thrift institutions, or industrial loan companies.

The differences between the products of banks and non-bank financial firms have become increasingly blurred. The emergence of similar products by different firms operating under different regulatory regimes results in complicated competitive and regulatory issues.

A number of commercial banks engage in little or no traditional banking—funding commercial loans with deposits. Rather, they specialize in trading activities, consumer finance, or fee-based services.

Capital markets have become increasingly globalized, and financial markets in different countries have become more interdependent.

Technological innovations such as remote banking and digital cash daily redefine the nature and delivery of financial services and the respective roles played by bank and non-bank firms. For example, the data processing firm EDS is the second largest owner/operator of ATMs in the US.

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The traditional commercial bank may soon be extinct. But the banking industry is not facing change alone. Finance in general is merging and evolving, especially as the Internet revolution affects all financial services. Internet brokerage firms, for example are competing with banks. Charles Schwab & Co. announced in July of 1998 that it was planning to begin online banking. This would include an online checking account that could be used to pay bills. E*trade Group Inc. was providing online loan applications. Other brokers were seeking to provide insurance as well as loans online. "This is the biggest single threat that the commercial banks face right now." In October of 1998, Prudential, the English life insurer, announced that it was beginning a direct banking operation. In October of 1998, residential mortgages were being offered online through the Internet by several companies. Consumers were allowed to bid for mortgages and to negotiate their terms without appearing at a bank. The SEC is grappling with day traders, Internet trading and electronic communications net-
works ("ECNs") that are undermining the structure of the traditional full service brokers and threatening the role of the exchanges. The financial futures industry is facing competition from electronic trading systems in Europe that have taken over the lead from American exchanges. Exchange traded futures are also

count broker that became a part of Ameritrade Holding Corp. See The Road to the Internet, WALL St. J., June 2, 1999, at C1. Ameritrade announced in 1997 that it would charge only $8 in commissions for listed stock trades through the Internet. See Rebbecca Buckman, How Far Can Online Rockets Carry Ameritrade?, WALL St. J., Apr. 15, 1999, at C1. Charles Schwab Corp. also introduced an Internet trading system, "e.Schwab," which offered stock trading for a commission of $29.95 for trades up to 1,000 shares. By September of 1998, Charles Schwab was executing over 50% of its customers' trades online, an increase of some 36% from the prior year. At that time, there were some 80 online brokerage firms. See The Future of Trading, N. Y. TIMES, Feb. 17, 1997, at Y27; The Road to the Internet, WALL St. J., June 2, 1999, at C1; Dave Pettit, Logged On, The Rush to Trade Online is Changing the Nature of Individual Investing for Both Investors Themselves and the Businesses That Serve Them, WALL St. J., Sept 8, 1998, at R6. By 1999, 200 brokerage firms were providing online trading. See Brokerage Business Will Set Records for 1999, Decade, Industry Data Show, WALL St. J., Dec. 29, 1999, at C19. In February of 1999, some 7.5 million accounts were trading online. That was an increase from 1.5 million in 1996. The growth of this market was pushing up the value of the stock of the online brokers. By 1998, Schwab's stock market value exceeded Merrill Lynch's. See The Road to the Internet, WALL St. J., June 2, 1999, at C1; Joseph Kahn, Schwab, For Now, Bests Merrill on Strength of On-Line Trading, N.Y. TIMES, Dec. 29, 1998, at C1.

330. Instinet Corp., the largest electronic communications network, was processing 170 million shares per day in 1999. Twenty million of those trades were executed after traditional trading hours. See Rebecca Buckman, Plan by Chicago Exchange to Offer Extended Trading is Sign of the Times, WALL St. J., Aug. 23, 1999, at C11. Instinet was partnering with brokers to increase its trading volume. See Rebecca Buckman, Island ECN Raises Capital to Become a Stock Exchange, WALL St. J., May 11, 1999, at C20.

331. ECNs were reducing the market share of both the New York Stock Exchange and NASDAQ. ECNs were handling about 25% of NASDAQ volume at the end of 1998. See Rebbecca Buckman, Island ECN Raises Capital to Become a Stock Exchange, WALL St. J., May 11, 1999, at C20.

These changes were worrisome to the SEC. The Chairman of the SEC announced in 1999 that he wanted to centralize all electronic trading so that all orders would be displayed and available to everyone. See Gretchen Morgenson, S.E.C. Chief Wants One Site for Posting All Stock Prices, N. Y. TIMES, Sept. 24, 1999, at A1. In reality, the Chairman's concerns were a recognition by the SEC that technology was defusing the distribution of financial services and placing their distribution out of the SEC's reach. Only by centralizing those services will the SEC be able to regulate securities products effectively under its existing regulations.

332. Futures exchanges in the United States maintain an antiquated auction sys-
being challenged by unregulated over-the-counter derivatives.333

The insurance industry is under assault from banks and other segments of the financial services industry, and insurance companies are themselves intruding into other non-traditional areas of finance. For example, insurance companies are selling variable insurance products that are regulated by the SEC as securities.334 A recent reorganization of Aetna insurance company illustrates this process. That company divided itself into two groups: health-care insurance and "financial services." The latter unit is responsible for a number of financial services that include many securities related products.335 The insurance industry is also being restructured as the communications revolution and competition from banks and broker-dealers undermine the role of the independent agents that previously were responsible for the delivery of much of the insurance products sold in America.336 Insurance companies were making di-

333. A report by the General Accounting Office in 1994 estimated that the notional amount of OTC derivatives outstanding at the end of fiscal year 1992 was at least $12.1 trillion, this in addition to some $5.5 trillion of foreign exchange contracts that were being conducted largely by banks. See United States General Accounting Office, Financial Derivatives, Actions Needed to Protect the Financial System 34 (1994) available at 1994 WL 930437. Over 1,200 different financial derivative products were being offered to institutional investors. See Albert R. Karr, Bank Regulator Signals Move on Derivatives, WALL ST. J., April 21, 1994, at A3. They included such things as "death backed bonds," "worthless warrants," "inverse floaters," "heaven and hell bonds," swaptions, embedded options, synthetic indexes, synthetic stocks, barrier options, down-and-out options, deferred stop and start options, lateral options, look back options and exploding options. See Jerry W. Markham, Protecting the Institutional Investor -- Jungle Predator or Shorn Lamb? 12 YALE J. ON REG. 345, 353 (1995); Elayne Sheridan, SCM's Capitalize on OTC Business, FUTURES INDUSTRY MAG., Nov./Dec. 1993, at 26, 29.

334. Because variable products are securities, the insurance industry was being subjected to regulation by the SEC. See generally SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959). Insurance companies were required to establish "separate" accounts to hold their reserves for their securities-based products such as variable annuities and variable life insurance. The assets held in those separate accounts were in excess of $400 billion by 1995. This was an increase of over 30% from 1994. Common stock constituted over 60% of those assets. See American Council of Life Insurance, 1996 Life Insurance Fact Book 107 (1996).


336. Concern was being expressed that the independent insurance agent "may be
rect sales to consumers. Allstate Insurance Company announced in November of 1999 that it would be selling car and home insurance directly to consumers through the Internet and over the telephone. Online companies were also helping consumers to buy insurance on the Internet. One service allowed consumers to review the offerings of fifty major insurance companies so that they could find the best product. This allowed consumers to compare prices.

Financial engineering has melded commercial and investment banking together. It has blended derivatives into securities products, and it has combined insurance with other financial services. Consumers may buy these products from separate firms or they may opt for a single provider, which may be a bank, a brokerage firm, an insurance company or even a mutual fund. As one author has noted, there have traditionally been:

relatively distinct ‘borders’ between what an insurance company, a bank, and a securities firm could do.

Each industry operated within its compartment – the

headed the way of the milkman.” See John R. Wilke & Leslie Scism, Under the Gun: Insurance Agents Fight an Intrusion by Banks, But Other Perils Loom, WALL ST. J., Aug. 8, 1995, at A1. Insurance agencies’ profits were down and their numbers had been sharply reduced. There were some 80,000 independent insurance agencies in the United States in the middle of the 1950s. See id. That number fell to 41,000 by the mid-1990’s. See id.


339. One writer has pointed out that, “we are witnessing the virtual disappearance, nominally, of the ‘life insurance agent’ as this person is now being renamed ‘financial planner’.” Howard J. Saks, Merging of the Life Insurance and Securities Industries Accelerates, 25 EST. PLAN. 326 (Aug./Sep. 1998). This change was due to the fact that many insurance agents and securities brokers were cross-licensed. See id. at 328. Insurance companies developed securities operations while broker-dealers developed insurance businesses. See id.

340. “Almost all the bigger brokerage houses and mutual funds now offer a range of insurance-type products ….” CHARLES R. MORRIS, MONEY GREED, AND RISK, WHY FINANCIAL CRISES AND CRASHES HAPPEN 197 (1999).

Fidelity Investments was the largest mutual fund company at the end of 1999. It was also the third largest Internet broker and was allowing its customers to trade after regular market hours. See Fidelity to Allow After-Hours Trading, NEWS & OBSERVER (Raleigh), Nov. 11, 1999, at D2. Fidelity was offering its customers other financial services including an American Express gold card, as well as a Visa debit card. See John Hechinger & Paul Beckett, Fidelity to Offer American Express Cards, WALL ST. J., May 5, 1999, at C25.
insurance companies sold insurance, banks took deposits; and securities firms bought and sold equities. In today's world, both insurance and securities firms have financial instruments similar to bank deposits. In many countries, the banks have taken over insurance companies and securities firms and now offer their services. All three organizations actively sell financial expertise around the world, using technology and wide-ranging corporate know-how.341

"And just like the commercial banks, life insurance companies are struggling to reinvent themselves and become more like stock brokerages and investment banks."342

The merger of Citicorp and the Travelers Group, which owned Salomon Brothers and Smith Barney,343 combined insurance, banking, derivatives, and securities services under one giant umbrella. This financial giant faces a multitude of regulators even though it will be targeting the same customers for many of its services. Those regulators include the Fed, the Treasury (Comptroller of the Currency), various state banking commissions, the FDIC, the SEC, state securities administrators, SIPC, the CFTC, state insurance regulators, self-regulatory bodies (i.e., stock and commodity exchanges, the NASD and the NFA), and a host of others such as the Pension Benefit Guaranty Corporation and the Federal Trade Commission. Other financial institutions in America face similar phalanxes of regulators.

The Treasury Department has noted that "[i]n light of the changing market shares, the emergence of new financial products and technology, and the disintegration of traditional industry and product lines . . . , there needs to be a fundamental reassessment of why and how we regulate financial firms."344 Unfortunately, this

341. See Zagaris & MacDonald, supra note 281, at 67 n. 19.
342. See Morris, supra note 340, at 197.
344. Dept. of the Treasury, Memorandum for Members of the Secretary's Advisory Commission on Financial Services from Joan Affleck-Smith, Director, Office of Financial Institutions Policy (Oct. 23, 1995) (italics omitted).
process has not occurred. As a result of the combining of financial services, there is simply no basis to support the continuation of the historical "functional" regulation that put banking, securities, insurance and derivatives into isolated regulatory boxes administered by legions of regulators. Functional regulation in no way reflects current realities. As one bank regulator has noted, the "'business of banking' has changed drastically... since the National Bank Act was enacted to support a national currency, and no one expects banks today to be restricted to the practices that then constituted the 'business of banking.' The adaptability of the national banking system will become increasingly important as advances in technology and telecommunications accelerate the rate of change."\textsuperscript{345}

The regulatory structure for financial services even in earlier years was of questionable value. The stock market crash of 1929, the great depression, disintermediation and the series of financial crises that began in the 1960s and culminated in the S&L crisis were not alleviated by regulation. Indeed, regulation could rightly be blamed for accentuating those crises. History has also witnessed dramatic changes in the nature of financial services since those events. The growth of the institutional investor is affecting the way the market operates. Such investors now dominate the market, and they can trade large quantities through ECNs without the aid of an exchange or even a broker.\textsuperscript{346} The Internet is turning financial services into a commodity that can be purchased on the basis of price, just as is the case for a book or a set of golf clubs. Improved search engines and Internet access will soon allow comparison shopping


\textsuperscript{346} One of the "most profound developments" in the securities industry has been the increase of stock ownership by institutions. "Only four decades ago, ninety percent of U.S. equities were held by individuals. Today, more than half of all stock is controlled by institutions." See NEW YORK STOCK EXCHANGE AND THE WHARTON SCHOOL, THE POLICY IMPLICATIONS OF STOCK OWNERSHIP PATTERNS 1 (1993). Institutional investors are in a position to "increasingly dominate United States securities markets in terms of total assets and volume of trading (doing about 55 percent of all New York Stock Exchange trades)." See U.S. CONGRESS, OFFICE OF TECHNOLOGY ASSESSMENT, ELECTRONIC BULLS AND BEARS, U.S. SECURITIES MARKETS AND INFORMATION TECHNOLOGY 6, n.8 (1990). Institutions were accounting for more than 80% of all trading volume in the stock markets in 1992. See PETER L. BERNSTEIN, CAPITAL IDEAS, THE IMPROBABLE ORIGINS OF MODERN WALL STREET 4 (1992); JAMES E. BUCK, THE NEW YORK STOCK EXCHANGE, THE FIRST 200 YEARS 182 (1992).
and information access on a basis that would have been inconceivable only a few years before. Wal-Mart and other retailers are already trying to include financial services in their product mix.\footnote{Wal-Mart was not alone. Nordstrom, Inc., a department store chain, was granted permission to acquire a thrift so that it could offer home equity loans and money market checking accounts. See Matt Murray, Retailers Use Legal Wrinkles to Link Sales, Bank Services, WALLST. J., Feb. 8, 1999, at B1. Sony, "the inventor of the Walkman and the PlayStation," plans to begin Internet banking and has already set up a joint venture into online securities transactions. See Bayan Rahman, Sony branches out into internet banking venture, FIN. TIMES, Dec. 11-12, 1999, at 1. Sony also announced that it was planning to enter into a joint venture with an online brokerage firm. See id.}

The repeal of the Glass-Steagall Act's restrictions on investment banking would seem to be a recognition that financial services

\footnote{Wal-Mart was not alone. Nordstrom, Inc., a department store chain, was granted permission to acquire a thrift so that it could offer home equity loans and money market checking accounts. See Matt Murray, Retailers Use Legal Wrinkles to Link Sales, Bank Services, WALLST. J., Feb. 8, 1999, at B1. Sony, "the inventor of the Walkman and the PlayStation," plans to begin Internet banking and has already set up a joint venture into online securities transactions. See Bayan Rahman, Sony branches out into internet banking venture, FIN. TIMES, Dec. 11-12, 1999, at 1. Sony also announced that it was planning to enter into a joint venture with an online brokerage firm. See id.}

After its initial public offering, the largest ever, UPS decided to expand its delivery business by creating a subsidiary to sell financial services that would include credit guarantees, inventory financing, equipment leasing and factoring. See Betty Liu, UPS Moves into Financial Services, FIN. TIMES, Dec. 6, 1999, at 15. ING Group's mutual fund unit is teaming with others to create links with more than 50 web retail firms in order to promote mutual fund sales. See Aaron Lucchetti, Shop and Save? E-Tailers Allow Buyers To Add Fund Investments to Their Carts, WALLST. J., Dec. 21, 1999, at Cl. Merrill Lynch was also opening up its online services to allow customers to buy non-financial products such as books from Barnes & Noble and wine from "virtual vineyards." See Charles Gasparino & Randall Smith, Internet Trades Put Merrill Bulls on Horns of a Dilemma, WALLST. J., Feb. 12, 1999, at Cl.

One need only have visited the Harris Teeter grocery store in Chapel Hill at end of the last century to see how far the financial services revolution has spread across traditional lines. CCB, a large North Carolina Bank, has a kiosk selling a broad array of financial services including checking and asset management accounts, mutual funds, and an ATM is available for cash withdrawals. A few steps away is a display selling a software package by E*Trade, an online broker, that allows consumers to trade stocks and other securities on the Internet for $49.95.

This revolution has been underway for some time. Sears Roebuck & Co. had earlier tried to trade "stocks and socks." Sears bought Coldwell Banker in October of 1981. Coldwell Banker was then the largest real estate firm in the United States. See Thomas J. Lueck, Sears to Buy Coldwell Banker in Big Expansion, WALLST. J., Oct. 6, 1981, at A2. Three days later, Sears' agreed to buy Dean Witter, Reynolds, the fifth largest securities broker. See Paul A. Gigot & Thomas J. Lueck, Financial Forays, Sears Expansion Brings Increased Competition to Bankers and Brokers, WALLST. J., Oct. 12, 1981, at A1. It was Sears strategy to become the largest financial services company in the United States. See Tim Carrington, The Year They Sold Wallstreet 212 (1985); Greg Burns, Not Many Mistakes in Century of Success, CHICAGO SUN-TIMES, Sep. 30, 1992, at 62. Oddly, Sears had little trouble selling stocks. Instead, it was foundering on its dry goods business. In September of 1992, Sears sold Dean Witter Financial Services Group, Coldwell Banker, and the Sears Savings Bank. These sales were necessary to help Sears pay off $3 billion in corporate debt incurred from losses in its catalogue and store sales. See Mary Ellen Podmolik, Sears Announces Breakup, CHICAGO SUN-TIMES, Sep. 29, 1992, at 8, available in 1992 WL 3487866. At that time, Dean Witter was the third largest brokerage firm in the country and was posting record profits. See generally David Dishneau, Sears Sheds Brokerage, Real Estate Units, ASSOCIATED PRESS, available in 1992 WL 5318401 (Sep. 29, 1992).
can no longer be placed in separate boxes by Congressional fiat. But that repeal is really only the beginning of the process for creating a regulatory structure that is appropriate for modern financial services. Other than for reasons of expediency, it is difficult to justify Congress’ decision to continue and endorse this functional regulatory structure.

The efficacy of the present functional system is being called into question in other ways. The derivative dealers are virtually unregulated. Federal regulators are seeking to continue the current non-regulated environment for over-the-counter derivatives. Synthetic products can replicate securities markets and operate outside the reach of the CFTC and SEC. A well-known economist recently listed fifteen different ways to take a stock market position without buying the stock, and many of those methods involved unregulated activity. The Task Group on Regulation of Financial Services that was chaired by Vice President George Bush in 1984 made some effort to address the need for changes in the regulatory structure. The Task Group concluded that “the American financial market is the central nervous system of the economy” and that there was too much regulation. Seven federal financial agencies were regulating financial services, and they had over 38,000 full-time employees who were intruding into virtually every aspect of finance. The Task Group cautioned, however, that there was danger in concentrating regulatory authority into a single regulator. The Task Group’s report noted that “[t]hroughout American history, no single government authority has ever been entrusted with

348. As one author has noted: “The long-term regulatory tendency will be toward a more sharply tiered system of oversight, based not on institution type but on the financial function being performed, the presence of systemic risk, and the relative competence and power of the parties to a transaction.” Morris, supra note 340, at 241.


350. See id. at 238.

351. See Blueprint for Reform: The Report of the Task Group on Regulation of Financial Services (Nov. 14, 1984). The Task Group included the Secretary of the Treasury, the Attorney General, the Director of the Office of Management and Budget and the Chairman of the Fed, as well as the heads of several other agencies regulating financial services.

352. See id. at 8.

353. See id.
regulatory authority over all American banks."\textsuperscript{354}

The Bush Task Force had little effect on the regulatory structure. The Treasury Department submitted legislative proposals in 1991 to rationalize bank regulation, but it too was ignored. The Clinton administration submitted a report to Congress in 1993 that proposed the establishment of a Federal Banking Commission that would have regulated all FDIC-insured depository institutions and their holding companies and affiliates. This new agency would have combined the functions of the Comptroller of the Currency, the Fed, the FDIC and the Office of Thrift Supervision. The Fed would have continued its role in administering monetary policy. This proposal was ignored.\textsuperscript{355}

In connection with the Clinton administration's review of financial services, The Chicago Mercantile Exchange ("CME") proposed the creation of a single department for financial services regulation.\textsuperscript{356} That proposal would have continued functional regulation in various sub-departments. The CME proposal was stillborn. The government in Great Britain has opted for a more central based regulator that cuts across financial service product lines.\textsuperscript{357} That model will undoubtedly be closely followed for possible application here. Nevertheless, the creation of such a body raises several concerns. It could stifle competition, it could over-regulate and cause a loss of competitive position in international markets. Such a monolithic body could try to become a Japanese Ministry of Finance

\textsuperscript{354} See id.
\textsuperscript{355} See MACEY & MILLER, supra note 136, at 69-71.
\textsuperscript{357} The Labor government in England gave the Bank of England authority to set interest rates. See Labour's Good Start, \textit{The Economist}, May 10, 1997, at 14. At the same time, the government removed the bank's long-held authority to supervise other banks in England. That authority was transferred to the Securities and Investments Board, which was already exercising supervisory authority over brokerage firms. Financial regulation in the United Kingdom was then centralized. The government announced that it was planning to place more responsibility on a Financial Services Authority and less on self-regulation for securities and other financial services. See Labour Turns to the City, \textit{The Economist}, May 24, 1997, at 14. The Financial Services Authority was to be a "super regulator." See Edward Luce, \textit{London Stock Exchange Faces Curbs}, \textit{Fin. Times}, Oct. 4, 1999, at 1. It will take responsibility for the Securities and Investments Board, The Securities and Futures Association and the Personal Investments Authority, as well as the former regulatory functions of the Bank of England. See Richard Dedman, \textit{Inside Track}, \textit{Fin. Times}, Jan. 7, 2000, at 10.
and "plan" the economy by hiring brilliant bureaucrats to make economic decisions for millions of consumers who, if given the choice, would probably prefer to make those decisions themselves.

A better approach would be to abandon the functional product based regulatory model entirely. The merging of financial services and the blending of products makes such an approach outmoded. Instead, attention should be directed to the realities of the marketplace. Who needs regulation and who does not are the first issues to be addressed. The securities industry has long recognized that institutional and other sophisticated market participants do not need the same protections as the proverbial widows and orphans of the world. Consequently, sophisticated "accredited" investors are exempted from much of the onerous regulation imposed on those firms dealing with "retail" customers. That approach should be carried across all financial services. This could mean, for example, that financial institutions could open unregulated deposit accounts with a bank that would not be subject to reserve requirements or have deposit insurance. The sophisticated depositors using these accounts could make their own credit risk

358. See Jerry W. Markham, Protecting the Institutional Investor — Jungle Predator or Shorn Lamb?, 12 YALE J. ON REG. 345 (1995). "It was understood, even before the enactment of the Securities Act of 1933, that institutional investors did not need the mandatory disclosure system of that Act to protect themselves when acquiring securities. These investors could 'fend for themselves'." See Joel Seligman, The Transformation of Wall Street, A History of the Securities and Exchange Commission and Modern Corporate Finance 570 (1995).

359. Financial services are converging at both the retail and institutional levels. See Finance and Economics: The new financiers, THE ECONOMIST, September 4, 1999, at 69. This means that functional regulation is no longer practical for either retail customers or institutional distributors.

360. The H.R. 10 restrictions on investment banking contained a provision that would have allowed the creation of something called "wholesale financial companies" ("woofies"). See H.R. 10, 105th Cong. (1998). The bill would have allowed investment banking firms to operate a bank that would only have institutions as customers and would have no deposit insurance. The legislation, however, would have imposed capital and other restrictions on the operations of woofies and would have subjected them to regulation by the bank regulators. The investment banks advocating this legislation lost interest in this proposal, and the provision was dropped from the legislation that was eventually enacted. See Leslie Wayne, Push for Wholesale Banks Stalls in Overhaul of Law, N.Y. TIMES, July 7, 1999, at C2. Nevertheless, such a format, sans regulation, would be an appropriate vehicle for isolating institutional activities in a holding company structure that contains retail customer operations. Investment banks and broker-dealers are already using special purpose, bankruptcy remote affiliates to handle over-the-counter derivatives business.
assessment and hedge against defaults through derivatives. The banks offering these accounts could place them in a separate subsidiary or those institutional deposits could be subordinated to the claims of insured retail depositors. Similarly, banks and brokerage firms could continue to underwrite and sell securities and derivatives to accredited investors without registration.

Banks should be able to conduct proprietary trading without undue regulatory hindrance. They should be able to participate in ECNs and compete fully with brokerage firms. At the same time, banks should be stripped of regulatory protections such as those that preclude commercial firms like Wal-Mart from competing for retail customer deposits. There is no economic basis for such artificial restraints. Banks and other institutions should be disciplined by the market just like the rest of the economy. Banks and other institutions have the wherewithal to make credit assessments and to negotiate and enforce any protections that might be needed. The role of regulators in financial transactions conducted among institutions would be left to systemic concerns. That would largely involve providing liquidity in times of crisis and monitoring monetary policy.

361. There is an active market for credit derivatives that allow participants to buy or sell credit risk. Default swaps are the most popular of these instruments. Under such agreements, if the borrower defaults, the seller will take over the debt at face value. See Credit Derivatives, Fixing the Holes, THE ECONOMIST, Aug. 14, 1999, at 61; Is There Money in Misfortune?, THE ECONOMIST, July 18, 1998, at 67. This not to say that risk has been eliminated with these instruments. Concern is being expressed as to what constitutes a default and what exactly is to be paid when there was a default. See Credit Derivatives, THE ECONOMIST, Dec. 5, 1998, at 101. Most large financial firms have their own credit departments and internal controls to protect themselves from undue counter-party exposures. They are backstopped by the rating agencies. See generally Frank Partnoy, The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies, 77 Wash U.L.Q. 619 (1999) (discussing role and limitations of rating agencies).

362. A former SEC Commissioner has suggested a regulatory structure that would divide regulation into systemic consumer protection, but he would add two more agencies that would regulate deposit insurance and market structure. See Morris, supra note 340, at 239.

The regulatory role of the government should otherwise be limited to protecting small investors. This would involve the prosecution of fraudulent sales practices that are directed to unsophisticated retail customers. This could include such things as prohibitions against "churning" of securities and commodity accounts, "twisting" of insurance policies, "switching" of mutual funds, fraudulent claims of performance and similar matters affecting retail financial services. Another aspect of this regulation would involve protection of customer funds that are on deposit with a retail financial services firm. This would include such things


The LTCM affair also illustrates why the existing overlapping structure is in need of replacement. The CFTC used that event as the basis for launching an effort to regulate OTC derivatives and to set the stage for preempting SEC regulation over OTC derivative dealers. See David Barboza and Jeff Gerth, Who's In Charge? Agency Infighting and Regulatory Uncertainty, N. Y. TIMES, Dec. 15, 1998, at C14; Michael Schroeder, Born, Again, WALL ST. J., Nov. 3, 1998, at A1. The Fed, the SEC and the Treasury Department opposed the CFTC inquiry because of concerns that it would destabilize markets. See Michael Schroeder, CFTC Chairwoman Won't Halt Study of OTC Derivatives Rules, WALL ST. J., June 11, 1998, at C1; Michael Schroeder, Treasury, Fed and SEC Appeal to Halt CFTC Plan to Review OTC Derivatives, WALL ST. J., June 8, 1998, at B11C. Congress was forced to enact legislation to stop the CFTC. See generally David Barboza & Jeff Gerth, Who's In Charge? Agency Infighting and Regulatory Uncertainty, N. Y. TIMES, Dec. 15, 1998, at C14. In the meantime, the SEC spent a great deal of effort to create something called "Broker-Dealer Lite" that was intended to create a registration category with reduced regulation. The OTC derivative dealers had structured their operations to avoid more onerous SEC regulation, sometimes by locating their activities off-shore. The SEC thought that reduced regulation would entice these dealers back into the regulatory fold. As of January 10, 2000, only one firm had registered with the SEC as a Broker-Dealer Lite.

364. One goal of consumer protection should be education. All too many financial frauds involve claims of exorbitant profits with limited risk. No one should be allowed to graduate from high school without a basic understanding of the relationship between risk and reward. Just as every student knows that $2 \times 2 = 4$, every schoolchild should be taught that a claim of large profits without commensurate risk is not possible. Similarly, high school students should be taught the time value of money, how leverage works and the effects of commissions and fees on their investment returns. They also need to understand the nature of investments in mutual funds, stocks and bonds, including their attendant risks.
as capital and reserve requirements (which are now converging as VAR and similar risk assessment programs become popular), segregation of funds and administration of deposit insurance. Truth-in-lending, fair credit reporting and collection practices, equal credit opportunity and similar laws would fall under this part of the regulatory structure. Trade practices would be another aspect of consumer protection. This would include such things as insider trading, manipulation and other market practice issues.

All of this retail regulation could be conducted by a single regulator, but the brief of that agency must be consumer protection. It should not be the dictation of market structure, the determination of who can market particular financial services, or the form of the financial services to be offered. Further, even retail consumer regulation should give way to market discipline whenever possible. For example, the government's exposure from the risks associated with deposit insurance should be laid off on private insurers and that cost should be passed on to the consumers receiving the benefit through the retail outlets for those services. Many broker-dealers already carry private account insurance for amounts in excess of those covered by SPIC. For example, Charles Schwab recently announced that it had arranged for insurance from the Travelers Casualty and Security Company of America that would provide an additional $900,000 of coverage for cash in a securities account and for coverage for the net equity value of a securities account in excess of the SPIC coverage. The existence of a credit derivatives market should facilitate this risk shifting process. In addition, as one Fed official has suggested, even unsophisticated consumers should be given the option of buying unregulated products. That proposal

367. See Oliver I. Ireland, Fed Associate General Counsel, New Regulatory Models
is not as revolutionary as it sounds. Consumers already have the choice of depositing their funds either in an uninsured money market account or in an insured bank or thrift account. Such choices should be expanded.

IV. CONCLUSION

Banking and other financial services have come a long way since Alexander Hamilton and Robert Morris proposed the creation of a central bank. In the meantime, the country has struggled almost continuously with the proper role of government in the regulation of banking and other financial services. As a result of that history, "functional" regulation has been imposed in which particular groups of state and/or federal regulators are assigned the duty of regulating specified activities conducted by specific entities such as commercial banks, insurance companies, futures commission merchants and broker-dealers. The revolution in finance that occurred in the last quarter of the twentieth century, however, has rendered such a system obsolete. Financial services are now being offered across those traditional functional and institutional lines. The repeal of the Glass-Steagall Act's investment banking restrictions only underscores this change. Although Congress wants to keep regulation in its traditional boxes, those boxes no longer exist. The growth of financial service offerings on the Internet will only accentuate the diffusion of those services. At the same time, many consumer financial services are escaping regulation almost entirely because they do not fit traditional norms. Reform is needed that will take into account the ongoing restructuring of financial services.
