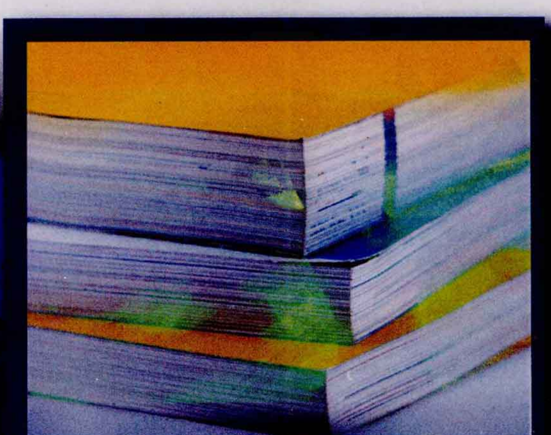
Financial Institutions and Services

Modernizing Financial Regulation



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Lawrence P. Cowell
Editor

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FINANCIAL INSTITUTIONS AND SERVICES

MODERNIZING FINANCIAL REGULATION

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EDITOR

Nova
Nova Science Publishers, Inc.
New York

PREFACE

The current U.S. financial regulatory system has relied on a fragmented and complex arrangement of federal and state regulators, put into place over the past 150 years, that has not kept pace with major developments in financial markets and products in recent decades. As the nation finds itself in the midst of one of the worst financial crises ever, the regulatory system increasingly appears to be ill-suited to meet the nation's needs in the 21st century. This book explores a framework for modernizing the outdated U.S. financial regulatory system to help policymakers weigh various regulatory reform proposals and consider ways in which the current regulatory system could be made more effective and efficient.

Chapter 1 - Today, financial services, banking, insurance and securities trading are no longer specific to an institution, but are delivered by almost every financial services institution in most cases with little or no differentiation. Since the 1980s, financial services companies increasingly commingle products and services. The passage of P.L. 106-102, the Gramm-Leach-Bliley Act (GLBA), incorporated the commingling of financial services within institutions into U.S. financial services law. In this new GLBA framework, the responsibilities of regulating financial institutions are more difficult to achieve because their business activities have become more interrelated.

Technological advances have helped to erase the traditional lines of demarcation in financial services products upon which the regulatory structure was built. Bank regulators, for example, continue to lower barriers to bank entry into commodity futures and the options business, and insurance has become a popular bank product. As bankers get more involved in the securities business, the business has been changing rapidly. As financial instruments or products become more complicated, the riskiness (probability of default) of the products is more difficult to determine for regulatory purposes. Maintaining a regulatory structure and control based on past market demarcations that are now slowly disappearing raises questions about the effectiveness of the regulatory structure that has responsibility for the safety and soundness of the financial institutions under its jurisdiction.

This chapter is a brief overview of the U.S. federal financial services regulatory structure. The first section is a brief historical analysis of the functional and competitive regulatory structure of the three major financial services — banking, insurance, and securities, including commodities futures and options. The second section deals with the difficulties in regulating institutions when they begin to provide services outside their demarcated lines of business. The third section discusses some of the recent proposals to consolidate regulatory agencies in the United States. The fourth section briefly assesses the consolidated financial services regulatory structures in the United Kingdom, Japan, and Germany, and the report concludes with some implications.

Chapter 2 - As the financial services industry has become increasingly concentrated in a number of large, internationally active firms offering an array of products and services, the adequacy of the U.S. financial regulatory system has been questioned. GAO has identified the need to modernize the financial regulatory system as a challenge to be addressed in the 21st century. This chapter, mandated by the Financial Services Regulatory Relief Act of 2006, discusses (1) measurements of regulatory costs and benefits and efforts to avoid excessive regulatory burden, (2) the challenges posed to financial regulators by trends in the industry, and (3) options to enhance the efficiency and effectiveness of the federal financial regulatory structure. GAO convened a Comptroller General's Forum (Forum) with supervisors and leading industry experts, reviewed regulatory agency policies, and summarized prior reports to meet these objectives

Chapter 3 - The United States and other countries are in the midst of the worst financial crisis in more than 75 years. While much of the attention of policymakers understandably has been focused on taking short-term steps to address the immediate nature of the crisis, these events have served to strikingly demonstrate that the current U.S. financial regulatory system is in need of significant reform.

To help policymakers better understand existing problems with the financial regulatory system and craft and evaluate reform proposals, this chapter (1) describes the origins of the current financial regulatory system, (2) describes various market developments and changes that have created challenges for the current system, and (3) presents an evaluation framework that can be used by Congress and others to shape potential regulatory reform efforts. To do this work, GAO synthesized existing GAO work and other studies and met with dozens of representatives of financial regulatory agencies, industry associations, consumer advocacy organizations, and others. Twenty-nine regulators, industry associations, and consumer groups also reviewed a draft of this chapter and provided valuable input that was incorporated as appropriate. In general, reviewers commented that the report represented an important and thorough review of the issues related to regulatory reform.

Chapter 4 - This chapter is based upon a statement of Gene L. Dodaro, Acting Comptroller General of the United States, before the Congressional Oversight Panel on Financial Regulation who discussed a January 8, 2009, report that provides a framework for modernizing the outdated U.S. financial regulatory system. We prepared this work under the authority of the Comptroller General to help policymakers weigh various regulatory reform proposals and consider ways in which the current regulatory system could be made more effective and efficient. My statement today is based on our report, which (1) describes how regulation has evolved in banking, securities, thrifts, credit unions, futures, insurance, secondary mortgage markets and other important areas; (2) describes several key changes in financial markets and products in recent decades that have highlighted significant limitations and gaps in the existing regulatory system; and (3) presents an evaluation framework that can be used by Congress and others to shape potential regulatory reform efforts. To do this work, we synthesized existing GAO work and other studies and met with representatives of financial regulatory agencies, industry associations, consumer advocacy organizations, and others. The work upon which the report is based was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. This work was conducted between April 2008 and December 2008.

Chapter 5 - This chapter is based upon a speech made by Timothy F. Geithner, President and CEO, Federal Reserve Bank of New York, at the Economic Club of New York, June 9, 2008, who spoke about reducing systemic risk in a dynamic financial system.

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In: Modernizing Financial Regulation
Editor: Lawrence P. Cowell

ISBN: 978-1-60741-442-1

Chapter 1

FEDERAL FINANCIAL SERVICES REGULATORY CONSOLIDATION: AN OVERVIEW

Walter W. Eubanks

SUMMARY

Among the arguments offered for consolidating the federal regulatory structure of the financial services industry is that the industry has changed in ways that blur the clear- cut boundaries between the functional areas of banking, insurance, securities, and commodities markets. It has also been argued that while the financial services firms are primarily responsible for effectively managing their risks, the new nature of those risks has created a need for the government to take a more comprehensive approach to financial regulation. Moreover, a consolidated financial services regulator at the national level is more suited to accommodate international regulatory negotiations on financial services regulations such as capital, accounting, and privacy standards. The most recent proposal to consolidate the federal regulatory structure is the *Department of the Treasury Blueprint for a Modernized Regulatory Structure* (page 13), which would merge several federal regulatory agencies' functions into five distinct functional supervisory agencies. The proposal consolidates regulatory functions, not agencies.

Even though a number of proposals to consolidate the federal regulatory structure of the financial services industry have been put forth, the United States has yet to make any significant move to do so. A key reason is that the functional, competitive regulatory structure of the United States was, and continues to be, viewed by most policymakers and knowledgeable observers as being sound over time, despite a number of crises. For example, significant federal regulation of banks first occurred during the Civil War when states' management of their currencies failed dramatically. In another example, financial regulators addressed the savings and loan associations failures of the 1980s with risk-based capital requirements for all insured-depository institutions for the first time. The Sarbanes-Oxley Act established accounting standards for publicly traded companies in response to the accounting

frauds leading to the bankruptcy of several large publicly traded firms. The structure has often been able to successfully address such problems quickly before they disrupt the economy.

To improve their ability to regulate the modern financial services sectors, many countries including the United Kingdom, Japan, and Germany have recently consolidated their financial services regulatory agencies. Financial Services Authority of the United Kingdom (FSA-UK), the Financial Services Agency of Japan (FSA- Japan), and the Federal Financial Supervisory Authority (BaFin) in Germany provide a point of comparison for the U.S. regulatory structure. These foreign regulatory structures are said to offer more effective methods of regulating modern financial services firms.

This chapter is a brief overview of the U.S. federal financial services regulatory structure. It briefly provides an historical analysis of the current U.S. functional and competitive regulatory structure. It discusses some of the recent proposals to consolidate the U.S. regulatory agencies, and it assesses three consolidated financial services regulatory structures abroad.

INTRODUCTION

Today, financial services, banking, insurance and securities trading are no longer specific to an institution, but are delivered by almost every financial services institution in most cases with little or no differentiation. Since the 1980s, financial services companies increasingly commingle products and services. The passage of P.L. 106-102, the Gramm-Leach-Bliley Act (GLBA), incorporated the commingling of financial services within institutions into U.S. financial services law. In this new GLBA framework, the responsibilities of regulating financial institutions are more difficult to achieve because their business activities have become more interrelated.

Technological advances have helped to erase the traditional lines of demarcation in financial services products upon which the regulatory structure was built. Bank regulators, for example, continue to lower barriers to bank entry into commodity futures and the options business, and insurance has become a popular bank product. As bankers get more involved in the securities business, the business has been changing rapidly. As financial instruments or products become more complicated, the riskiness (probability of default) of the products is more difficult to determine for regulatory purposes. Maintaining a regulatory structure and control based on past market demarcations that are now slowly disappearing raises questions about the effectiveness of the regulatory structure that has responsibility for the safety and soundness of the financial institutions under its jurisdiction.

This chapter is a brief overview of the U.S. federal financial services regulatory structure. The first section is a brief historical analysis of the functional and competitive regulatory structure of the three major financial services — banking, insurance, and securities, including commodities futures and options. The second section deals with the difficulties in regulating institutions when they begin to provide services outside their demarcated lines of business. The third section discusses some of the recent proposals to consolidate regulatory agencies in the United States. The fourth section briefly assesses the consolidated financial services regulatory structures in the United Kingdom, Japan, and Germany, and the report concludes with some implications.

THE MAJOR FINANCIAL SERVICES REGULATORS

There are currently seven major federal regulators for the financial services industry. The following is a summary of the supervisory duties of the Office of the Comptroller of the Currency (OCC), the Federal Reserve System (the Fed), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), the National Credit Union Administration (NCUA), the Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission (CFTC). All these agencies regulate for safety and soundness. The SEC and the CFTC emphasize consumer protection more than the others.

- **The Office of the Comptroller of the Currency (OCC)** The OCC is the regulator for just under 2,000 nationally chartered banks, and the U.S. branches and offices of foreign banks. The OCC conducts on-site examinations of each national bank at least three times within every two-year period.

- **The Federal Reserve System (Fed)** The Fed supervises about 950 state-chartered commercial banks that are members of the system and more than 5,000 bank holding companies and financial holding companies. Along with the OCC, it also supervises some international activities of national banks. The Fed uses both on-site examination and off-site surveillance and monitoring in its supervision process. Each institution is examined on-site every 12 to 18 months. The Fed's in-house examiners are to examine larger institutions continuously. The Board of Governors of the Fed coordinates the examination and compliance activities of the 12 regional banks.

- **The Federal Deposit Insurance Corporation (FDIC)** The FDIC regulates about 4,800 state-chartered commercial banks and 500 state-chartered savings associations that are not members of the Fed. They also insure deposits of the remaining 4,000 depository institutions without regulating them. The FDIC examines its supervised institutions about once every 18 months.

- **The Office of Thrift Supervision (OTS)** The OTS supervises about 950 federally chartered savings associations, savings banks, and their holding companies. Like the OCC, the OTS is located within, but is independent of, the Treasury. The OTS is to conduct on-site examinations of each institution at least three times every two years.

- **The National Credit Union Administration (NCUA)** The NCUA currently regulates 9,369 federally chartered credit unions and another 3,593 federally insured, state-chartered credit unions. Most credit unions are small and considered to have limited risk exposure. Consequently, credit unions and NCUA are not covered further in this chapter.
- **The Securities and Exchange Commission (SEC)** The SEC regulates to protect investors against fraud and deceptive practices in securities markets. It also has authority to examine institutions it supervises for regulatory compliance. This covers securities markets and exchanges, securities issuers, investment advisers, investment companies, and industry professionals such as broker-dealers. The SEC supervises

more than 8,000 registered broker-dealers with approximately 92,000 branch offices and 67,500 registered representatives.

- **The Commodity Futures Trading Commission (CFTC)** The CFTC protects market users and the public from fraud and abusive practices in markets for commodity and financial futures and options. The CFTC delegates regulatory examinations to its designated self-regulatory organizations (DSROs), of which the most prominent are the National Futures Association (NFA), the Chicago Board of Trade, and the New York Mercantile Exchange. NFA membership covers more than 4,000 firms and 50,000 individuals. The regulatory process generally starts at registration, when the DSRO screens firms and individuals seeking to conduct futures business. The DSROs monitor business practices and, when appropriate, take formal disciplinary actions that could prohibit firms from conducting any further business.

SAFETY AND SOUNDNESS REGULATIONS

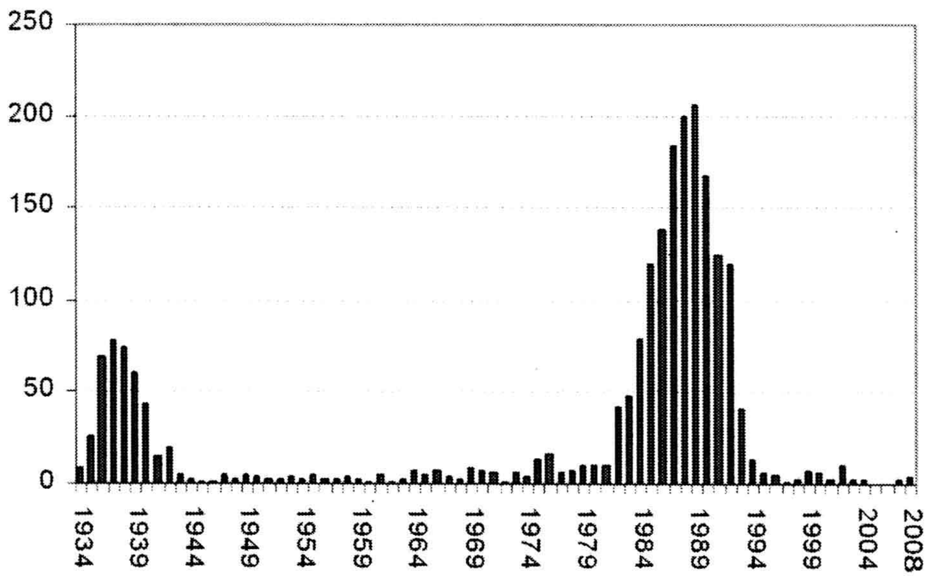
Safety and soundness regulations for banks consist of basically five components: **federal deposit insurance** to reduce the likelihood of bank runs and panics; **deposit interest ceilings** to reduce the costs of bank deposits and weaken banks' incentives to invest in risky assets; **regulatory monitoring** to ensure that banks do not invest in excessively risky assets, have sufficient capital given their risk, have no fraudulent activities, and have competent management; **capital requirements** to provide incentives for banks not to take excessive risk; and **portfolio restrictions** to prohibit investment in risky assets.

Under regulatory monitoring, U.S. banking regulators adopted a uniform rating system known as CAMEL to monitor banks' safety and soundness. "C" stands for capital adequacy; "A" stands for asset quality; "M" stands for management ability, "E" stands for earnings, and "L" stands for liquidity. The bank's capital is evaluated on the basis of the bank's size as well as the composition of its assets and liabilities, on and off the balance sheet. The quality of the bank's assets is determined by assessing the bank's credit risk of loans in its portfolio, which are classified as good, substandard, doubtful, or loss. Management ability is determined by evaluating the bank's management as well as its board of directors. The examiners assess competence, management acumen, integrity, and willingness to comply with banking regulations. Earnings are evaluated in terms of trends relative to the bank's peers. In determining the bank's liquidity, the examiners assess credit conditions, deposit volatility, loan commitments, and other contingent claims against the bank's capital, current stock of liquid assets, and the bank's perceived ability to raise funds on short notice. From the list of regulators above, one can see that bank examiners have overlapping jurisdictions. For example, national banks are also FDIC-Insured. Often federal and state examiners accept each others' examinations, and sometimes they examine jointly. It is important to note that it is illegal to disclose a bank examination (for example, CAMEL ratings) outside the bank.[1]

BACKGROUND

A number of proposals to consolidate the federal regulatory structure of the financial services industry have been put forth. The United States, however, has yet to make any significant move in this direction. One reason is that most policymakers and knowledgeable observers believe that the functional, competitive regulatory structure of the United States has proven sound over time.[2] For example, the number of bank (a key financial services provider) failures would be among the indicators of the health of a financial services structure. **Figure 1** indicates that the number of bank failures have declined, since it peaked during the S&L crisis in 1989 when 206 depository institutions failed.

Figure 2 shows the ratio of the deposits of the failed institutions to the total deposits of FDIC-insured depository institutions (failed institutions' deposits divided by total deposits). At its peak in 1991, 124 institutions failed but only a little more than 2% of the total banking deposits were held by these failed institutions. In contrast, at the end of 2006 no depository institution failed for the first time two in consecutive years since 1934. But the subprime turmoil that started in August of 2007 and the credit crunch that followed contributed to the failure of three small banks in 2007 and four in the first quarter of 2008.

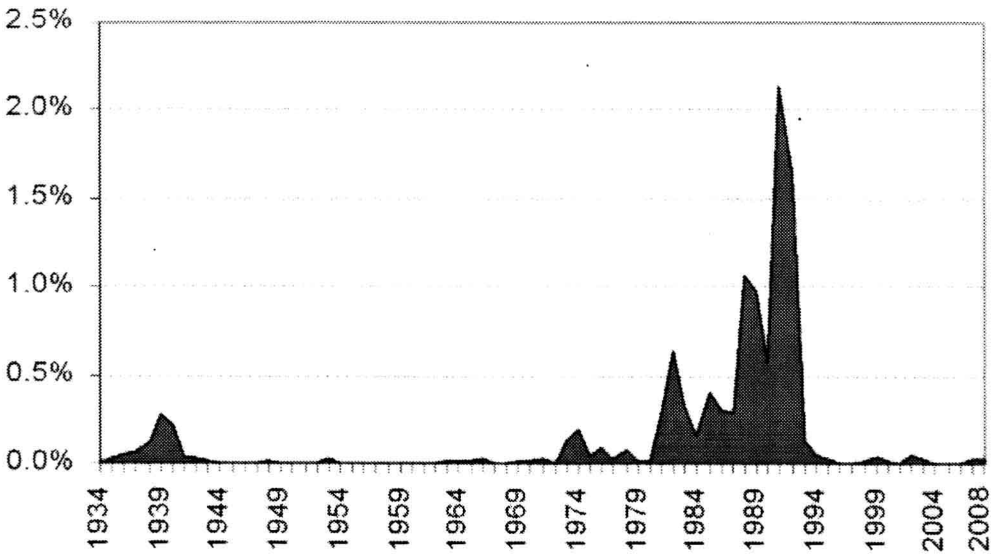


Source: FDIC 2007Annual Report. Appendix A, p.107, and FDIC 2008 Failed Bank List, [http://www.fdic.gov/about/strategic/report/2004highlight/arhighlight.pdf], and [http://www.fdic.gov/bank/individual/failed/banklist.html].

Figure 1. The Number of FDIC-Insured Bank Failures, 1934-2008

The regulatory structure of the United States is said to be functional because regulators supervise by line of business such as banking, insurance, or securities trading. The structure is said to be competitive because there are usually multiple regulators responsible for a single function, for example, banking services.[3] Regulatory responsibilities are widely dispersed among several regulators on the federal as well as the state level of government.

The U.S. regulatory structure reflects historical evolution rather than deliberate design. The structure has evolved by addressing regulatory deficiencies on whatever level they are found. For example, federal regulation of banks occurred for the first time after the Civil War when states' management of their currencies failed dramatically. For the first time in the 1980s, the financial regulators addressed the savings and loan associations'(S&Ls) failures by abolishing the Federal Saving and Loan Insurance Corporation (FSLIC), creating the OTS as the S&Ls' new regulator and requiring all insured-depository institutions to increase their capital by calculating their regulatory capital based on the riskiness of their assets. The purpose was to increase the protection of taxpayers from future bailouts of these institutions. More recently, the Sarbanes-Oxley Act created a new independent body, the Public Company Accounting Oversight Board to oversee auditors and established accounting standards for publicly traded companies in response to accounting fraud leading to the bankruptcy of several large publicly traded firms. In most cases, the U.S. regulatory structure has been able to handle most financial crises successfully before they significantly disrupt economy activity. The issue is the regulatory structure's capacity to continue to handle most financial crises given the increased interrelationships and functional commingling within the financial services industry.



Source: FDIC 2007Annual Report. Appendix A, p.107, and FDIC 2008 Failed Bank List, [http://www.fdic.gov/about/strategic/report/2007highlight/arhighlight.pdf], and [http://www.fdic.gov/bank/individual/failed/banklist.html].

Figure 2. FDIC-Insured Bank Deposits: Ratio of Failed Bank Deposit to Total Bank Deposits, 1934-2008

The United Kingdom, Japan, and Germany recently consolidated and redesigned their financial services regulatory agencies to meet recent developments in the financial services markets. These recent developments included the blurring of boundaries among functions, need for a comprehensive approach to risk management, better allocation of regulatory resources, and the need to accommodate international regulatory negotiations on trade in financial services.

The Financial Services Authority in the United Kingdom (FSA-UK), the Financial Service Agency in Japan (FSA-Japan), and the Federal Financial Supervisory Authority (BaFin) in Germany provide a point of comparison for the U.S. structure. These foreign regulatory structures are said to offer more effective methods of regulating modern financial services firms.

U.S. Functional and Competitive Regulatory Structure

U.S. regulation of financial services is dispersed among a number of regulators. For example, the FDIC and the OCC have regulatory responsibilities for national banks that are FDIC-insured. The OCC holds these banks' charters, and therefore determines the activities in which they may engage. The FDIC insures each of the institutions' deposit accounts for up to $100,000 on which it must make good if the institutions fail. Proponents of the framework contend that competing regulatory bodies regulate less but do it more efficiently. The redundancy of regulators is more likely to detect and correct risky market behaviors before they develop into financial crises.[4]

The structure allows regulations to be tailored to the specific deficiencies at the appropriate level of the abusing firm(s). Also, the structure promotes innovations and competition among financial services providers. Opponents argue that the overlapping regulations are costly and allow astute financial services firms to exploit weaknesses along the regulatory seams. The structure also allows financial services providers to shop for the regulator that best suits their business plan. This was confirmed in a recent FDIC survey that shows that the top reasons given by the 34 banks that changed their charter to the FDIC were that "the FDIC was less expensive and more banker friendly, and that other regulators were stricter, and that institutions could more readily pursue market share increases."[5] On the other hand, the ability to shop for regulators could lead to more institutions being regulated by the weakest regulators, which would increase systemic risk.

Regulatory Competition in Banking

In the beginning of the nation, the federal government exercised an indirect role in the regulation of banking through the First and Second Banks of the United States. When President Andrew Jackson refused to renew the Second Bank's charter, states' regulatory banking commissions filled the regulatory vacuum that was created.[6] The Civil War and the disarray of the national currencies led to the reintroduction of the federal government into regulating banks by establishing the national bank charter system, which was governed by the Comptroller of the Currency (OCC) established in 1863.[7] Its creation immediately began the dual banking system which exists today and placed the federal government in competition with states for the number and size of banks under their respective jurisdictions. Until recently, most bankers preferred state charters because states' regulations were considered less burdensome.

More layers to the regulatory structure, and therefore competition between regulators, were added with the creation of the Federal Reserve Board after the Panic of 1907 and the creation of the Federal Deposit Insurance Corporation (FDIC) after the banking failures of the Great Depression in the 1930s. Further layers of regulatory competition were added when saving banks and credit unions were provided with separate federal regulators which evolved into the Office of Thrift Supervision (OTS) and the National Credit Union Administration (NCUA).[8] The Great Depression also led Congress to pass the Glass-Steagall Act of 1933 (Ch.89, 48 Stat. 162) to further seal off banking from other financial services enterprises by prohibiting banks from engaging in investment banking activities until it was repealed by the Gramm-Leach-Bliley Act of 1999 (GLBA) (P.L. 106-102). It repealed the Glass-Steagall Act and allows financial companies owning or operating institutions to commingle financial services.

Regulatory Competition in Insurance

Like banking, the insurance industry owes its competitive regulatory structure to correcting deficiencies. States began regulating insurance in 1837, starting with Massachusetts and New York, to ensure that insurance companies maintained adequate reserves to meet claims.[9] In the early 1920s, states significantly increased legislative restrictions on insurance companies, starting in New York and copied by other states. A New York legislature's investigation uncovered massive insurance companies' abuses that left them without adequate reserves to pay claims. That led to the New York state's legislature passing laws barring companies from underwriting insurance while underwriting other securities.

Copying New York state's regulations, states separated insurance companies from the banking industry.[10] These regulatory provisions also protected the insurance industry from the excesses of the securities industry in the late 1920s that led to the stock market crash. Consequently, when the stock market crashed in 1929, the insurance companies were in relative good shape.[11] Having escaped the massive failures of the other parts of the financial services sector, the insurance companies were not included in New Deal regulatory legislation, even though in 1934 the Securities and Exchange Commission (SEC) proposed a federal agency to regulate insurance companies. The proposal was soundly rejected upon objections from the industry and state regulators.[12]

Another possible expansion of federal regulation of insurance came in 1944 out of a Supreme Court ruling which held that the insurance industry was subject to the federal antitrust laws.[13] The insurance industry feared that this ruling would preempt their state regulation. As a result, the industry lobbied Congress heavily to pass the McCarran-Ferguson Act, which granted insurance companies immunity from the antitrust laws to the extent that they were regulated by state insurance laws.[14] The McCarran-Ferguson Act protected the insurance industry until the early 1950s when insurance companies began selling variable annuities, which the SEC challenged. The SEC argued that variable annuities were securities subject to its regulation because the returns on these investments were based on investment of the annuitants' premium payments in securities. The Supreme Court found for the SEC. Insurance companies selling variable annuity contracts are now regulated by states and the SEC.[15]

The insurance industry was able to stave off other federal intrusions, despite suffering significant losses from contracts sold in the 1980s.[16] The industry, however, could not avoid competition from the banking and securities industries.[17] One reason was that variable annuities became a growing line of financial services products sold by stockbrokers. In addition, federal bank regulators began allowing banks to sell insurance products in the 1990s.[18] This competition resulted in many insurance companies demutualizing[19] and expanding their own financial service offerings, such as more securities-like products with banking services options.[20] In sum, even though regulatory competition was maintained with the states, state insurance regulators could not protect insurance companies from competition from other financial services providers. There have been several legislative proposals in recent years to impose federal regulation on some companies who offer securities- like products with banking services options.[21]

Regulatory Competition in Securities

When the Securities and Exchange Commission was created by Congress in 1934 — in the wake of the stock market crash of 1929 — it was to establish a strong federal regulatory presence in the market for corporate securities.[22] The SEC's main focus was full disclosure in the securities markets. The Securities and Exchange Act of 1934 did not preempt state securities regulations. Consequently, the SEC has competed with state securities regulators for most of its existence.[23] With the exception of mortgage-backed securities in 1984, it was not until the National Securities Markets Improvement Act of 1996 that some of the states' securities regulations were preempted or states were required to conform their standards to those of the SEC.[24] Federal securities law and SEC regulations apply to the markets where securities are traded and to all businesses that sell stocks or bonds to public investors. Other regulated entities include mutual funds, bidders in corporate mergers and acquisitions, certain investment advisers, public accountants, and power utilities (the SEC has some control over the market structure under the Public Utility Holding Company Act of 1935).[25]

In this securities regulatory structure, regulatory competition remains in the form of self-regulatory organizations (SROs). These are non-governmental organizations that were given regulatory authority and shelter from the antitrust laws by the Securities and Exchange Act of 1934.[26] SROs like the securities exchanges and the National Association of Securities Dealers, Inc. (NASD) are required to regulate the conduct of their members. The SEC's role is to oversee the exchanges, as well as act directly when the SROs' oversight fails.[27]

In addition to the SROs, the structure of securities regulation also includes accountants that certify the financial statements of public companies and broker- dealers as well as the Nationally Recognized Statistical Ratings Organizations (NRSROs). The NRSROs include rating agencies such as Moody and Standard & Poor's. The SEC's ability to enforce its rules over accountants and broker-dealers has been strengthened by the Sarbanes-Oxley Act of 2002, which created a Public Company Accounting Oversight Board to oversee the auditing principles of auditors. Sarbanes-Oxley also requires the SEC to conduct a study of NRSROs and to report to Congress on any deficiencies. Concerns about conflict of interest and certification have resulted in the Senate Committee on Banking, Housing, and Urban Affairs holding hearings on the regulation of NRSROs.[28]

Regulatory Competition in Commodity Futures and Options

Like the other financial services, commodities futures were separated from the rest of the industry as part of historical regulatory development in the United States. The agricultural recession of 1921 following World War I, and speculative manipulation of commodity prices prompted Congress to pass the Grain Futures Act of 1922 under its commerce powers.[29] The Grain Futures Act required commodity futures trading to be conducted on organized exchanges, such as the Chicago Board of Trade, which would register with the government as contract markets. With commodity speculation and market manipulation unchecked in the Great Depression, President Roosevelt added regulation of the commodity markets to his request for regulation of the securities market. Congress responded with the Commodity Exchange Act of 1936 (CEA), which continued many of the requirements of the Grain Futures Act, but required futures commission merchants (the equivalent to broker-dealers in the securities business) to register with the government.[30]

For decades, even though options trading of regulated commodities, and manipulation of commodity prices, were prohibited, the government was unable to stop speculation and manipulation in commodity prices, particularly in options on unregulated commodities which added to the rapid rise in commodity prices in the early 1970s. The Commodity Futures Trading Commission Act of 1974 was enacted in response to developments in the commodities markets which carried forward the Commodity Exchange Act and created the CFTC.[31]

The CFTC was given exclusive jurisdiction over the trading of commodity futures and commodity options on all commodities and it was given more enforcement powers than its predecessor. Its regulatory reach included commodity trading advisors, commodity pool operators, and associated persons of futures commission merchants.[32] Despite the increased federal regulation of the commodity trade, the regulatory control of commodity trade remained less stringent than SEC's control of trade in securities. Competition between the SEC and the CFTC developed when the financial services industry began developing new financial instruments and trading strategies that converged on products regulated by both regulators — stock index futures, and other equity-based derivatives. The difference in the level of regulation in the securities and the commodity futures and options markets became important to investors. Over-the-counter (OTC) instruments such as swaps, caps, collars, and floors were increasingly popular alternatives to exchange- traded commodity futures and options. Some of these instruments were abused by both SEC- and CFTC-regulated firms and traders. In 1978, Congress mandated that the two agencies consult with each other and with banking regulators in curtailing these abuses.[33]

The over-the-counter market for derivatives was the source of regulatory competition between the CFTC and the banking regulators — the Fed and the OCC. The banking regulators argued for no regulation of OTC financial derivatives, even though Congress had given the CFTC exclusive jurisdiction over all contracts and mandated that all such contracts be traded on CFTC-regulated exchanges. However, the CFTC did not move to assert its regulatory jurisdiction over these derivative contracts. The lack of regulation provided a legal risk to swaps contracts. That is, if a court had ruled that swaps were illegal, trillions of dollars in OTC derivative contracts might have been rendered void and unenforceable.[34]

The Commodity Futures Modernization Act of 2000 (CFMA; P.L. 106-554) was enacted to clarify the situation. It specifies that the CEA does not apply to contracts between "eligible contract participants" (which include financial institutions, regulated financial professionals, units of government, nonfinancial businesses or individual persons with assets more than $10 million, and others whom the CFTC may approve) based on "excluded commodities." Excluded commodities are defined as financial products and indicators, and are thought to be less susceptible to manipulation than physical commodities with finite supplies. Derivatives based on agricultural commodities, however, may be traded only on CFTC-regulated exchanges, because of concerns about price manipulation — "corners" and "squeezes" — in those markets.[35]

THE PROBLEM OF REGULATING IN THE CURRENT ENVIRONMENT

Today, financial services, such as banking, insurance and securities trading are no longer specific to an institution. Insurance, for instance, does not have to be bought from an insurance company; instead it can be purchased from a bank with little or no differentiation in the policy being delivered to the customer. Since the 1980s, financial services companies increasingly commingle financial services. The passage of P.L. 106-102, the Gramm-Leach-Bliley Act of 1999, incorporated the commingling of financial services within institutions into U.S. financial services law.

In this new GLBA framework, the responsibilities of regulating financial institutions are more difficult to achieve because the regulators no longer have the separation of the lines of businesses that they had in the past. Technological advances have helped to erase the traditional lines of demarcation in financial services products upon which the regulatory structure was built. Bank regulators, for example, continue to lower barriers to bank entry into commodity futures and options businesses, and insurance has become a popular bank product. As bankers get more involved in the securities business, the business has been changing rapidly. Maintaining a regulatory structure and control based on past established market behavior that is now slowly disappearing raises questions about the effectiveness of the structure to manage the changing risks. Most regulatory changes have occurred after the risks have risen sufficiently to show the deficiencies.

PROPOSED CONSOLIDATION SOLUTIONS

The most recent proposal to consolidate the federal regulatory structure of financial services industry is the *Department of the Treasury Blueprint for a Modernized Regulatory Structure (*the Blueprint). It was motivated by the Bush Administration's recognition that the existing functional regulatory framework no longer provides efficient and effective safeguards against poor prudential behavior of financial services firms.[36] The Administration